

**AUDIT/COMPLIANCE COMMITTEE
FOR THE BOARD**

TUESDAY 21, 2009

8:00 - 10:00 A.M.

GRAND 1ST FLOOR CONFERENCE ROOM

Palomar Pomerado Health
Internal Audit and Compliance
Board Committee

PPH Grand Office Bldg

Tuesday – July 21, 2009
8:00 – 10:00 A.M.

456 E. Grand. Escondido
Conference Room - 1st floor

A G E N D A

Call To Order

- Public Comments
- *Approval of Minutes – May 19, 2009

	<u>Item</u>	<u>Presenter</u>	<u>Mins</u>
1.	Welcome / Introductions <ul style="list-style-type: none"> • Marty Knutson, Corporate Compliance Officer • Donna Goh, Administrative Assistant 	T. Boyle/M. Knutson	5
2.	Report of Internal Audit Services Activities	T. Boyle	50
3.	Internal Audit Staffing	T. Boyle	5
4.	Deloitte & Touche Presentation 2009 Audit Plan	M. Kawauchi/ S. Dogra/L. Biggs	45
5.	Corporate Compliance Program	M. Knutson	10
6.	Open Discussion	ALL	5
6.	* Date/Time/Location of Next Meeting	Linda Greer	5

ADJOURNMENT

Linda Greer, Chairman	Janine Sarti, General Counsel	John Lilley, M.D.
Jerry Kaufman, M.A.P.T.	Bob Hemker, CFO	Lachlan Macleay, M.D,
Alan Larson, M.D.	Tom Boyle, Internal Audit Officer	Bruce Krider, M.A., Alt
Michael Covert, CEO	Marty Knutson, Corporate Compliance Officer	Anna Ha, Administrative Fellow
		Donna Goh, IA Assistant

NOTE: Asterisks indicate anticipated action; action is not limited to those designated items.

“In observance of the ADA, Americans with Disabilities Act, please notify us at (858) 675-5230, forty-eight hours prior to meeting so that we may provide reasonable accommodations”.

**Palomar Pomerado Health
INTERNAL AUDIT & COMPLIANCE
BOARD SUB-COMMITTEE MEETING**

PPH Corporate Building
456 E. Grand Ave.
1st Floor Conference Room
May 19, 2009

AGENDA ITEM/ PRESENTER/ORIGINATING DATE	DISCUSSION	CONCLUSIONS/ACTION	FOLLOW-UP/ RESPONSIBLE PARTY/FINALIZED
CALL TO ORDER	8:00am by Dir Greer. Quorum comprised of Directors Greer and Larson. Also attending: Janine Sarti, Michael Covert, Margie Drobatschewsky, Marv Levinson, MD, Bob Hemker, Lachlan Macleay, MD, Justin Kisner and Ken Hugins.		
NOTICE OF MEETING	Regrets from: Dir Kaufman Notice of Meeting was posted consistent with legal requirements.		
PUBLIC COMMENTS	None		
APPROVAL OF MINUTES	The minutes of March 20, 2009 were reviewed and approved.	MOTION: by Dir Larson, 2 nd by Dir Greer and carried to approve the March 20, 2009 minutes as submitted.	
<ul style="list-style-type: none"> • Update on RAC Revenue Audit Contractors 	Marv Levinson, MD highlighted the layers of review, in addition to RAC, that are looking at PPH. Margie reviewed the background of RAC. The RAC demonstration project's nationwide results, the PPH demo experience and the permanent program were reviewed. Dr. Levinson reviewed the appeal processes five levels and Margie discussed what has been put in place for RAC. The financial and administrative preparations and RAC readiness/risks were highlighted. The top five areas of exposure were identified by the RAC committee and RAC facts were discussed.	All in favor - none opposed. PowerPoint presentation available on the Leadership drive	
	The committee discussed the presentation at		

AGENDA ITEM/ PRESENTER/ORIGINATING DATE	DISCUSSION	CONCLUSIONS/ACTION	FOLLOW-UP/ RESPONSIBLE PARTY/FINALIZED
<ul style="list-style-type: none"> • Status of Dir of Corporate Compliance search 	<p>this point.</p> <p>Janine Sarti reported on the status of the recruitment for Director of Corporate Compliance.</p> <p>The first round of interviews is over and the field of candidates has been narrowed down to two individuals. The Board and the compliance committee will be interviewing the two candidates this week.</p>		
<ul style="list-style-type: none"> • Update on OIG Work Plan 	<p>Janine Sarti spoke on behalf of Tom Boyle. Mr. Boyle stated via email that he is not aware of any current OIG investigations related to the District at this time. As a proactive measure to minimize compliance risks, a subcommittee of the Compliance Oversight Committee evaluated the 2009 OIG Work Plan and assessed the relevant risks to PPH. As part of the process, several sets of issues were distributed to Directors responsible for specific subject issues including Home Health, Skilled Nursing Facilities, and Patient Financial Services. The subcommittee agreed that it would be valuable for the Compliance Officer and/or Compliance Auditor to perform audits of selected OIG risk areas on a regular basis throughout the year in order to maintain awareness of potential risks. This action would fall under the "monitoring" element of the compliance program.</p>		
<ul style="list-style-type: none"> • Report on Compliance Hotline activity 	<p>There have been three calls since the last report; two to the hotline and one directly to Janine Sarti.</p> <p>Two of the calls were compliance related calls and one was an HR issue.</p> <p>Ms. Sarti reported that the total compliance calls received in 2007 was five. There had been one in May, one in July, two in August and one in November. There had also been 459 contacts.</p>		
<ul style="list-style-type: none"> • Update on Internal Audit 	<p>Internal Audit completed a review of the</p>		

AGENDA ITEM/ PRESENTER/ORIGINATING DATE	DISCUSSION	CONCLUSIONS/ACTION	FOLLOW-UP/ RESPONSIBLE PARTY/FINALIZED
<p>Services</p>	<p>vendor master file and identified duplicates and possible duplicates for removal and/or follow up. This action will result in an automated tool to be developed by Internal Audit for Finance to use on a regular basis in order to monitor the accuracy of the file and identify/prevent fraudulent activity.</p> <p>An ACL user event was sponsored by the Internal Audit staff on Friday, May 15 with over 25 attendees from other industries and healthcare organizations throughout San Diego.</p> <p>A senior compliance auditor position has been posted and recruitment efforts are in place. Internal Audit worked closely with the Avega Committee by reconciling the rebuilding of files from Cerner.</p> <p>A report of the ROC was completed and will be reported to the Internal Audit and Compliance Committee at the June meeting. Mark Kawauchi of Deloitte and Touche will be able to attend the June meeting to make a presentation.</p> <p>Tom Boyle has been coordinating the construction audit of Rudolph and Sletten. The audit will be concluded by the end of the month. Mr. Boyle will work to collect any potential discrepancies owed to PPH. Other construction audit activities will continue and be reported subsequently.</p> <p>Internal Audit has developed a solution which enables the ROC committee to convert ECHO reports into a ACL readable format for development of DNFB reports.</p> <p>Decision Support is working with Internal Audit to provide a summary of total charges for Avega from selected encounters.</p> <p>Tom Boyle presented a session on Enterprise risk management to the EMT during the quarterly review.</p> <p>Tom Boyle presented a workshop on Medical Fraud in April to the Admission personnel in</p>		

AGENDA ITEM/ PRESENTER/ORIGINATING DATE	DISCUSSION	CONCLUSIONS/ACTION	FOLLOW-UP/ RESPONSIBLE PARTY/FINALIZED
<ul style="list-style-type: none"> • Report on Executive Expenses YTD 	<p>the County as a volunteer instructor for the American Hospital Association and Department of Health and Human Services.</p> <p>At the request of the committee Mr. Boyle identified all of the travel, credit card and miscellaneous expenses incurred and reimbursed to members of the Executive Management Team and the Board during the current fiscal year.</p> <p>All of the CEO's expense reports were selected and samples of each of the other EMT members were selected for review.</p> <p>The procedure requires Ted Kleiter to sign on all of the CEO's reports and it is apparent that this does in fact occur. It was found that separate credit cards are used by each EMT member. Summaries of expenditures have been made available for review and Tom will follow up to answer any questions regarding the individual transactions or the process in general. It was suggested that more detailed explanations be used by EMT and Board members when describing expenses for reimbursement, however, credit card expenditures contain only the merchant code.</p> <p>Bob Hemker will take this back to the Finance Committee.</p>		
<ul style="list-style-type: none"> • Open discussion • Date/Time & Location of next meeting 			
(FINAL) ADJOURNMENT	<p>June, 2009, 8:00a.m. in the corporate conference room @ 456 E. Grand.</p> <p>9:27am</p>	Dir Greer moved to adjourn. Dir Larson 2 nd motion.	
SIGNATURES			
<ul style="list-style-type: none"> ▪ Committee Chairperson 	<p>_____</p> <p>[Linda C. Greer, R.N.]</p>		
<ul style="list-style-type: none"> ▪ Secretary to Committee 	<p>_____</p> <p>[Nicole Dennis]</p>		

Palomar Pomerado Health
Internal Audit Activities Report for FY09 and FY10

TO: Audit/Compliance Committee for the Board of Directors

MEETING DATE: Tuesday, July 21, 2009

FROM: Tom Boyle, Internal Audit Officer

BY: Donna Goh

Background: Overview of audit activities for FY09 with positive results in cost savings, lowered staff time, reduced risks, and increased quality of information. These activities involved and benefited multiple key areas within PPH. Overview of other activities that were also accomplished by Internal Audit were reported. A highlight involving the construction audit is included with a mini-presentation provided. Shared initiatives for FY10 pave the road for another successful year for Internal Auditing activities to be accomplished.

Budget Impact: N/A

Staff Recommendation:

Committee Questions:

COMMITTEE RECOMMENDATION:

Motion:

Individual Action:

Information:

Required Time:

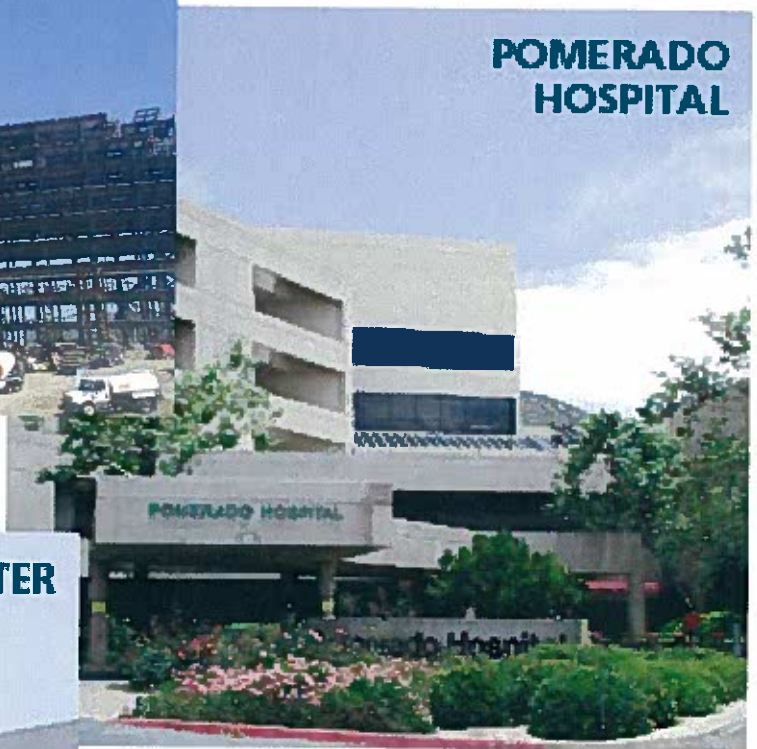
INTERNAL AUDIT SERVICES REPORT

July 21, 2009

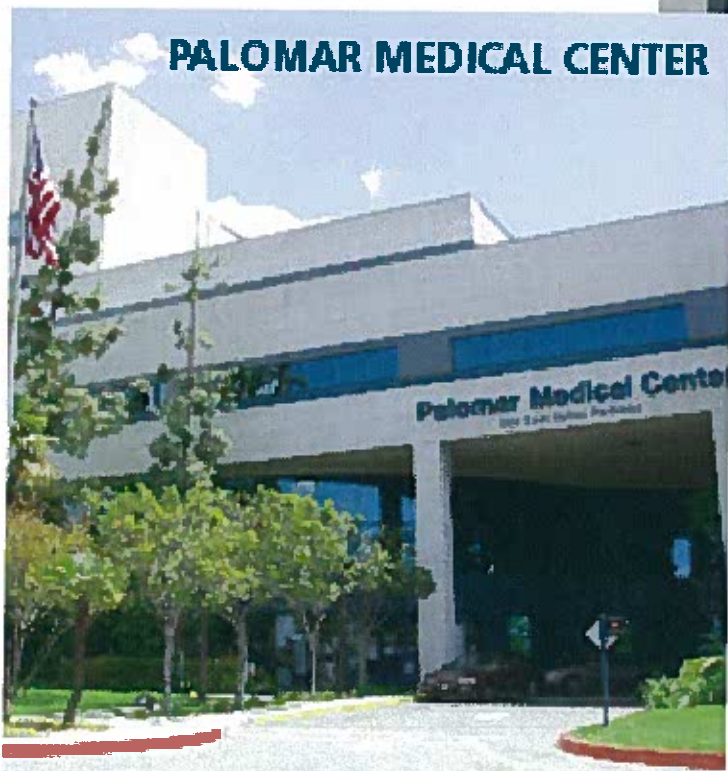
PMC WEST



POMERADO HOSPITAL



PALOMAR MEDICAL CENTER



PALOMAR
POMERADO
HEALTH
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Summary of FY09 Internal Audit Activities

1. Continuous Monitoring Activities

Internal Audit at PPH was early to embrace the concepts of “continuous monitoring” and “continuous auditing” as a means to increase audit effectiveness with fewer resources. With the availability of technology, these methodologies have been strongly supported and advocated throughout the audit and control professions as an effective and even critical means for attaining audit goals, particularly with limited resources. Following the reduction of the audit staff at the end of FY08, our primary effort was directed toward the development and implementation of this technology. Throughout the year, Internal Audit provided support to PPH operational areas in the form of data analysis, exception reporting and monitoring to a wide range of departments / stakeholders. These projects resulted in cost savings, lowered staff time, reduced risks and increased quality of information.

According to the audit plan, significant applications were successfully implemented which have benefited key the following operational areas of the organization:

- Managed care
- Revenue Cycle
- Compliance
- Finance
- Patient Financial Services
- Medical Staff
- Case Management
- Accounts Payable and Purchasing

Examples of the type and nature of the solutions developed include:

❖ Compliance/Clinical

- Developed an automated process and performed monthly examination of excluded providers as required by the Office of Inspector General.

- Evaluated the effectiveness of, and documented the excluded provider process.
- Performed ongoing analysis of Medicare patient classification with reports to the RAC coordinator and Clinical Resource Management.
- Development of a methodology using ACL to validate recipients of sensitive information in support of HIPAA compliance and information security.
- Ongoing analysis of lab and radiology activity for POM ICU.
- Ongoing summary of Medicare discharges by month.

❖ **Gained Efficiencies, Quality Improvement**

- Automation of daily census, (requested by Performance Excellence).
- Centralization of shared data (Internal Audit and other common users).
- Monthly expense report to all Directors (Finance).
- Unclaimed refunds (Finance, PFS).
- Development of a means to update data tables using changes from the last 24 hours as opposed to re-creating the entire table in order to reduce system impact.

2. Construction Audit Activities

A summary of Construction Activities is provided as a separate PowerPoint presentation to the Committee with a slide handout (Appendix A), highlighting the scope and results of audit efforts along with proposed scope and objectives in moving forward. The audit work has been performed as a cooperative engagement with MC Solutions, LLC, specializing in construction audit services. Additional staff has been added to the PPH expansion project team in an effort to improve controls and minimize potential audit findings for the future.

3. Special Investigations and Audits

In addition to the planned Continuous Monitoring activities, Construction Activities and supporting various operations with reports and analytics, the audit department continues to be a specialized resource for special investigations and ad hoc requests in areas to include Legal, Information Security, Compliance and Human Resources.

Other Activities

1. Conduct Enterprise Risk Assessment

This year, with the involvement of the other “Internal Consultants”, the Audit Risk Assessment process expanded to encompass more of an Enterprise Risk Assessment, with a broader scope to include ethics, culture, patient safety, and communications. The results were incorporated into the Executive Management Team’s efforts in the strategic planning process and the establishment of new initiatives.

2. PPH Consultative Activities

Participate in a variety of administrative committees and task forces on a regular basis to include:

- Chair the Compliance Oversight Committee
- Internal Consulting Group
- Revenue Optimization Committee (ROC)
- RAC Taskforce
- IT Steering Committee
- IT Security Oversight Committee
- Project Evaluation Team
- Financial Management Team
- PPH Foundation Audit Committee
- North County Health Development
- Baldrige Internal Examiners
- Management Group
- Leadership Council

3. ACL Training

Audit staff conducts regular training and provide technical support to other PPH staff members who currently use, or who would like to use ACL software. Current users include Managed Care, Patient Financial Services, Finance, Clinical Nurse Management, and Performance Excellence.

4. Professional and local activities

- Committee Member of the Association of Healthcare Internal Auditors
- Member of the International ACL Customer Advisory Board
- Health Ethics Trust, member of Best Practices Committee
- Founders, Directors of the San Diego ACL Users Group
- Faculty; Fraud Training for Hospital Association of San Diego and Imperial County
- Institute of Internal Auditors, San Diego Chapter
- Information Security and Controls Association, San Diego Chapter

FY 2010 Internal Audit Initiatives

1. Proceed with the Development of Continuous Monitoring Applications

Internal Audit is in the process of upgrading the existing data analysis system from the standard ACL software application to Audit Exchange which will provide additional benefits to PPH. The enhanced capabilities include the following benefits:

- A centralized warehouse of data elements and data assets which will significantly increase the control over data access, integrity of data, efficiency of data management, and consistency of processes.
- Access to financial and census data by department data analysts who use ACL.
- Handoff of continuous monitoring tasks to associated departments, which is a fundamental component of extended audit concept.
- The ability to report, monitor and support resolution of process anomalies found by the data analysts, particularly with a new web-based exception reporting capability.
- The ability to publish a browser-based, key-analytics dashboard.
- Training in the use of the new system so departments can utilize the power of ACL pursue their own business intelligence needs as well as improve and/or simplify existing, time-consuming, manual processes.

2. Continue with Construction Audits of PPH Expansion Projects

Internal Audit included construction audit activities as part of the regular audit plan in FY08 recognizing the need to continue and expand the scope of the audits, in correlation to the size and complexity of the expense outlay by the district. Early reviews focused on contract language review of invoices in respect to contract terms. In going forward into FY2010, the audit scope will extend to preventative controls in place, as well as segregation of duties and detective controls designed to identify inappropriate or excessive costs incurring through any major construction project. The decision was made at the start of the audit was to engage a construction audit specialist to work under the direction of the Audit Department, as opposed to hiring a full-time construction auditor. The

rationale was that a full-time auditor may not be cost-beneficial, especially considering the risk of turnover, vacancy as well as the depth and experience of an independent firm. This position will be re-evaluated as we proceed with the development and completion of construction audit reviews during this next year.

3. Projects to Support Organizational Initiatives

Pursuant to the establishment of the PPH FY10 Initiatives, The Internal Audit plan will contain activities which will support and monitor PPH initiatives to include:

- Providing resources and/or monitor effectiveness of activities performed by:
 - the revenue and resource optimization committees
 - selected service lines identified as focal areas
 - centralization of support services
- Evaluate and monitor adherence to contract terms with partnerships and local affiliates: Rady Children's Hospital, RehabCare, and North County Radiology.
- Adopt the adaptive design methodology and incorporate its recommendations or resolutions for operational inefficiencies. This methodology has significant potential in areas which include the revenue cycle, which will be taking on a charge master build/rebuild and clinical documentation integrity initiatives.

4. Replace Triage

In cooperation with the Managed Care department, we will develop a business plan as a proposal to internalize the retrospective audits of zero-balanced currently performed by an external contractor. By performing the work internally, and achieving the same results, we could potentially reduce expenses by \$100,000 or more, net of salaries.

5. Facilitate an Independent Quality Review of Internal Audit Function

It is a best practice in auditing, as well as other professions, to periodically perform a quality review in order to identify opportunities for improvement based on objective criteria. During FY2010 the Internal Audit department will participate in an independent quality assessment in order to identify areas where we could improve the effectiveness or professionalism of the department.

5. Perform a Comprehensive Audit and Compliance Risk Assessment

A fundamental and valuable responsibility of the internal audit function is to regularly perform a risk assessment in order to identify potential weaknesses within an organization's system of internal controls. As a result of economic instability, increased industry regulation, along with the dynamics of organizational culture and operational changes, both the scope and the need for such an assessment is evermore vital. The FY09 risk assessment was expanded to include cultural and other measures to establish a baseline for Enterprise Risk Management activities. During YF2010, we will be return to a comprehensive assessment of control risks to include compliance, fraud and ethics. The addition of a Senior Compliance Auditor to the staff will provide the opportunity for a more focused assessment of compliance risks and potentially monitor high-risk areas on a more regular basis. The formal risk assessment process will include surveys of leadership, interviews with key stakeholders, assessment of regulatory issues, relevance of changes in staffing/organizational processes and professional judgment. The resulting risk assessment will be a primary component in guiding the audit plan going forward.

6. Support the Compliance and Legal Departments

As a regular part of the audit plan, we anticipate providing timely and valuable support to both the Legal and Compliance departments in matters needing audit, investigation and analytic expertise. It is recognized that the skills needed in each of these areas are sometimes redundant and therefore, it is more effective and efficient for us to incorporate a team-approach to matters requiring specialized skills and expertise. Examples may include the regular investigation of Hot Line issues requiring the validation of data or historical records which are commonly familiar to and accessible by the audit staff.

**PPH Internal Audit Services Report
July 21, 2009**

APPENDIX A

PPH Construction Audit

Report to the Internal Audit and Compliance Committee

July 21, 2009



MC Solutions

Miller Consulting Solutions LLC

Benefits of the Construction Audit

- Ensuring that controls are developed and maintained – both PPH and contractor's controls
- Identifying overcharges/undercharges
 - (construction audit activities usually pay for themselves by providing a strategy that can result in significant savings, typically between one to five percent of the total construction project costs)
- Avoiding litigation – well managed and controlled projects have a lower incidence of conflict and thus are less likely to require court action to resolve disputes
- Reinforce fiduciary requirements (bond expenditures)

MC SOLUTIONS

Construction Audit Activities

First Interim Audit
Project's inception through the end of February 2007
Phase I of the Pomerado Hospital Expansion

Audit Objectives

- Review the Construction Manager's accounting records and compare to billed amounts
- Review the Construction Manager's bid process
- Review the labor reports and reconcile the labor charge to the billings
- Identify potential overcharges
- Review job site policies, processes and controls

Construction Audit Activities

First Interim Audit Results

- Evaluated and reinforced controls
- Ensured processes are working appropriately
- Recovered Overcharges of approximately \$230,000 relating to:
 - Classified Labor
 - Fuel
 - Consumables
 - Software
 - Unsupported reimbursable expenses
 - Unsupported invoices

Construction Audit Activities

Second Interim Audit
Construction Manager Rudolph and Stetten, Inc.

Work in process at Palomar

- Assessed the draft contract between Palomar and DPR
- Reviewed invoices for appropriateness of:
 - bill rates
 - reimbursable expenses
 - employee classification
- Performed a study of contractual labor rates and prepared a worksheet comparing rates to different multipliers

MC SOLUTIONS

Construction Audit Activities

Second Interim Audit
Progress to date (performed on-site)

- Reviewed:
 - support for invoices
 - trade contractor's files,
 - noted lien waivers, bonds, title certifications, etc.
 - bid files
 - insurance
- Interviewed R&S project personnel
- Tested labor hours (sample of timesheets vs. billed vs. job cost detail)
- Verified billed rates vs. job cost rates

Construction Audit Activities

Second Interim Audit
Progress to date (continued)

- Completed draft audit report
- Currently in negotiations with R&S
 - Potential issues surrounding:
 - Labor overcharges
 - Non-contractual rate increases
 - Invoice errors

Construction Audit Activities

Next Steps

- Complete R&S reconciliation
- Begin audit of the new Construction Manager, DPR
- Audit the trade contractors
- Complete a responsibility matrix to define, fine-tune and reinforce roles and responsibilities between personal and departments

Construction Audit Activities

Next Steps (continued)

- Review current roles of PPH staff to ensure optimal preventative controls exist.
Examples of tasks may include:
 - Daily review of timesheets
 - Audit of invoices before payment
 - Audit of equipment on site
 - Site counts of employees charged to the job
 - Confirmation of deliveries
 - Audits of tools and items charged to the job
 - Audits of back-charge items, etc.

Questions?

Contact:

- Tom Boyle, Internal Audit Officer
858-675-5542 Thomas.Boyle@pph.org

- Jeff Miller, President

Miller Consulting Solutions LLC
760-710-7018 Jeff@millerconsultingsolutionsllc.com

MC Solutions

**Palomar Pomerado Health
Deloitte and Touche Presentation 2009 Audit Plan**

TO: Audit/Compliance Committee for the Board of Directors

MEETING DATE: Tuesday, July 21, 2009

FROM: Deloitte and Touche Auditing Consultants

BY: Donna Goh

Background: A presentation by independent auditors, Deloitte & Touche, updating the Committee with their 2009 audit engagement supported by their tools and checklist.

Budget Impact: N/A

Staff Recommendation:

Committee Questions:

COMMITTEE RECOMMENDATION:

Motion:

Individual Action:

Information:

Required Time:

Deloitte.

Palomar Pomerado Health

2009 Audit Service Plan

Audit • Tax • Consulting • Financial Advisory.



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Our Audit Approach	5

Appendices:

Appendix 1—Audit Approach Flowchart

Appendix 2—Our Service Team

Appendix 3—Audit Timing

Appendix 4—Communications to the Audit Committee

Appendix 5—Engagement Letter

This communication is intended solely for the information and use of management, the Audit Committee, and others within the organization and is not intended to be and should not be used by anyone other than these specified parties.

Planned scope of our audit

We have been engaged to perform an audit of the financial statements of Palomar Pomerado Health (“PPH”) as of and for the year ended June 30, 2009, in accordance with auditing standards generally accepted in the United States of America (“generally accepted auditing standards”).

We have prepared the following comments, in accordance with AU 380, *The Auditor’s Communication with Those Charged with Governance*, related to the planned scope and timing of our audit to assist you in fulfilling your obligation to oversee the financial reporting and disclosure process for which management of PPH is responsible.

AUDIT OF FINANCIAL STATEMENTS

Our responsibility under generally accepted auditing standards has been described to you in our engagement letter dated June 30, 2009, a copy of which is included at Appendix 5. As described in that letter, the objective of a financial statement audit conducted in accordance with generally accepted auditing standards is to express an opinion on the fairness of the presentation of PPH’s financial statements for the year ended June 30, 2009 in conformity with accounting principles generally accepted in the United States of America, in all material respects. We consider PPH’s internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of PPH’s internal control over financial reporting. Accordingly, we will not express an opinion on the effectiveness of PPH’s internal control over financial reporting. Our consideration of internal control over financial reporting would not necessarily identify all deficiencies in internal control over financial reporting that might be significant deficiencies or material weaknesses.

PLANNED SCOPE OF THE AUDIT

We will plan and perform our audit to obtain reasonable assurance about whether the financial statements are free of material misstatement, whether caused by error or fraud.

Significant Risks

As of the date of this presentation, we have identified certain significant risks of material misstatement due to fraud or error. These risks and our plan to address them are as follows:

Significant Risk	Planned Procedures
Due to PPH’s outstanding bonds, the organization has significant public accountability	During the course of the audit, Deloitte will review transactions to ensure the substance equals the form. We will meet with management regularly to discuss key issues relevant to PPH.
Management Override of Internal Controls	We will (1) scrutinize areas of estimate or judgment for a pattern of bias, (2) examine documentation from independent sources, (3) inquire of others within or outside of PPH and (4) perform selection sampling using file interrogation software.
New Significant Transactions and Proper Accounting	From time to time, PPH enters into new joint ventures and/or partnership agreements, or dissolves existing ventures. We will work with management to understand all aspects of the transaction and read all related agreements to ensure the accounting for such transactions is appropriately reflected in the financial statements.

Unpaid Claims Liability (IBNR)	Deloitte actuaries will assist in evaluating whether PPH's estimates are reasonable. We will also perform detailed testing of the underlying claims data used to estimate the Incurred But Not Reported ("IBNR") liability.
Contractual and Bad Debt Allowances	Allowances are subject to management estimate. We will assess contractual and bad debt allowances based on historical collections and write-offs, and will perform detailed substantive procedures and internal control testing on individual financial classes.
Interest Rate Swaps	Deloitte valuation specialists will assist in evaluating whether the swap valuations are reasonable. We will also perform testing of the underlying data used to determine the swap valuations.
Accounting for 2009 Capital Appreciation Bonds	The 2009 Capital Appreciation Bonds may have complex accounting requirements due to the nature of the bonds. We will audit the accounting related to these bonds, and consult with our specialists, as needed, to ensure this issuance has been appropriately recorded in the financial statements.
Classification of Net Assets	This continues to be an area of focus. We will perform a focused level of testing in this area, specifically on the classification of net assets and appropriate presentation in the financial statements. We will review the internal control procedures management has in place to ensure that net assets are correctly classified.
Significant increase in Construction in Progress in fiscal 2009	Due to the significant increase in Construction in Progress ("CIP") in fiscal 2009, we will perform a focused level of testing related to CIP additions. Also, we will review PPH's methodology for capitalizing costs (including construction costs and interest expense) to ensure items are recorded in accordance with generally accepted accounting principles ("GAAP").
Revenue Recognition – Medicare prior year settlements, net premium revenue and deductions to revenue	We will perform focused procedures in this area to ensure revenue is recognized in accordance with GAAP and PPH's policy. We will also review the internal control procedures in place that may mitigate this identified risk.

We will separately communicate any additional significant risks that we might identify as we perform our audit procedures.

Internal Control

We plan to adopt a control-reliance strategy in the performance of our audit of the financial statements. The anticipated results of the tests of controls affect the nature, timing, and extent of our planned substantive audit procedures. When controls are operating effectively and consistently throughout the period of intended reliance, we can reduce the extent of our planned substantive tests and often perform the majority of those tests during an interim period. When controls are not operating effectively and consistently throughout the period of intended reliance, we rely less on the controls and more on detailed substantive audit procedures to support our opinion on the financial statements. Ineffective controls often require more focused substantive procedures to be performed closer to the balance-sheet date.

Materiality

Materiality is the amount we use as our basis for planning the scope of our audit of PPH's financial statements, and is the amount of misstatement we judge to be material to the financial statements on which we are reporting. The determination of materiality is a complex issue requiring consideration of qualitative and quantitative factors and is a matter of professional judgment taking into account our knowledge of the entity, our assessment of engagement

risk, and the reporting requirements for the financial statements. Our consideration of materiality is influenced by our perception of the needs of users of PPH's financial statements. The perceived needs of users are recognized in the discussion of materiality in Financial Accounting Standards Board ("FASB") Statement of Financial Accounting Concepts No. 2, *Qualitative Characteristics of Accounting Information*, which defines materiality as "the magnitude of an omission or misstatement of accounting information that, in the light of surrounding circumstances, makes it probable that the judgment of a reasonable person relying on the information would have been changed or influenced by the omission or misstatement."

Our Audit Approach

We will conduct our audit of PPH using the Deloitte audit approach as illustrated at Appendix 1, common documentation standards, and enabling software. This audit approach is the methodology we apply in providing professional services relating to the audit of financial statements. The common documentation and the enabling software enhance the consistent implementation of the audit approach and promote effectiveness and efficiency.

The Deloitte audit approach has the following key attributes. It is:

- **Partner-led** – The audit plan is driven by our partners' experience and detailed knowledge of PPH's business. The members of our core engagement team are listed at Appendix 2.
- **Focused** – We identify the risks associated with PPH, the audit engagement, internal controls, and potential errors in significant account balances or disclosures. We respond by designing appropriate audit procedures that focus on these risks.
- **Interactive** – We interact with PPH's management and the Audit Committee and respond to PPH's needs and expectations appropriately.
- **Dynamic** – We tailor our audit plan to respond to changing circumstances.

The audit approach supports a risk-based audit plan with a focus on understanding PPH's business and identifying risks associated with the financial statements. The approach requires the development of an audit plan that responds to these risks and to PPH's specific circumstances. It recognizes not only that entities are unique, requiring an audit plan tailored to their particular operations and financial reporting requirements, but also that professional environments and requirements vary.

Our audit approach is applied through the consistent application of six steps:



For the most part, these steps are performed chronologically; however, they are not rigidly applied. For example, once the audit plan has been developed and is being executed, we may become aware of a risk or required change in scope that was unknown during the initial planning phase. Based on the new information, we will reassess previously planned activities and adjust the audit plan accordingly.

Our approach is most successful when open and continuous communication with management and the Audit Committee is interwoven throughout the process. This audit plan is one of the steps in our efforts to communicate with the Audit Committee and management. We are committed to anticipating issues and minimizing surprises. One aspect of our professional responsibility is to bring appropriate items to the prompt attention of the Audit Committee and management. We will continue to consult with management and the Audit Committee openly and candidly on a variety of matters, including accounting and financial reporting issues, complex business transactions, and any emerging issues from regulatory or standard-setting bodies.

The Deloitte audit approach is effective by interweaving our year-round involvement, use of specialists and leading-edge audit technologies, and focus on continuous communication with management and the Audit Committee throughout the audit process.

- **Year-round involvement** – Our audit approach reflects our commitment to providing timely service that avoids last-minute surprises. This approach includes:
 - Timely interaction and consultation on significant business and accounting developments
 - Year-round availability of partners, specialists and staff

- Interim and final substantive and internal control audit procedures
- Audit of significant or complex transactions as they occur
- **Use of specialists** – The complexities of PPH's business and the challenges posed by the business and regulatory environment necessitate the involvement of professionals with a diverse set of skills and the experience needed to perform the applicable audit procedures. Specialized skills may be needed to perform audit procedures in the following areas:
 - Consideration of possible obsolescence or impairment of certain assets
 - Assessing the design and operating effectiveness of information technology and security controls
 - Accounting for estimates that involve valuation techniques
 - Accounting for estimates that involve actuarial techniques.
- **Leading-Edge Audit Technologies**—Deloitte is one of the world's leading professional services firms in the use of information technology and our firm is committed to continue to invest to maintain our technology leadership and provide an efficient and effective audit of the financial statements. Some of the tools we use include:
 - **AuditSystem/2 ("AS/2")**. AS/2 is an innovative software program that automates many of the functions of an audit. The software incorporates word processing, spreadsheet, and trial balance capabilities in a single program to facilitate integrated workpapers and report preparation.
 - **Audit Command Language ("ACL")**. ACL is a file interrogation package that we use to audit electronic data from our clients' systems. Its capabilities include data retrieval, financial analysis, and statistical sampling.
 - **Deloitte Accounting Research Tool**. A comprehensive online library that includes both internal accounting and auditing guidance and external professional, global, and industry-specific materials.
 - **Deloitte Audit Plus**. The Deloitte Audit Plus intranet site is an online knowledge network that covers the broad spectrum of Deloitte's intellectual capital. It provides access to best practices and metrics, a library of industry resources, and a directory of Deloitte specialists.

Plan

An effective and efficient audit cannot be achieved without thorough planning. Our extensive knowledge of PPH's business and industry allows us to develop a tailored audit plan that appropriately addresses the relevant organizational, internal control, industry, accounting, and financial reporting risks.

There are significant benefits to performing our procedures throughout the year. Accordingly, we perform interim procedures in order to properly identify risks, increase efficiency, and ensure timely issuance of reports.

We plan our audit to parallel the financial reporting and organizational structure of PPH based on our understanding of your business and internal controls, including entity-level and process-level controls. Our planning emphasizes business, control, and financial risk identification on a continuous basis. The matters and risks that concern management and the Audit Committee also concern us; our audit approach is tailored to focus on those risks and is flexible enough to allow adjustment as additional risks are identified.

The audit plan considers the financial reporting timetable of PPH and fosters the development of constructive, timely feedback to management regarding matters we believe warrant immediate attention. These include any significant issues identified throughout the year. Appendix 3 outlines our timing for the 2009 audit.

In developing the audit plan, we plan tests to obtain evidence regarding the design and operating effectiveness of relevant controls and we plan substantive auditing procedures to test the potential errors related to significant account balances or disclosures.

Our audit approach supports a risk-based audit plan. Certain financial statement items present greater-than-normal risk and require an enhanced focus, while other areas do not. The key areas of risk related to the financial statements that have been identified to date while performing our preliminary planning are listed in the "Significant Risks" section above.

The anticipated results of the tests of controls affect the nature, timing, and extent of our planned substantive audit procedures. When controls are operating effectively and consistently throughout the period of intended reliance, we can reduce the extent of our planned substantive tests and often perform the majority of those tests at an interim period. When controls are not operating effectively and consistently throughout the period of intended reliance, we rely less on the controls and more on detailed substantive audit procedures to support our opinion on the consolidated financial statements (i.e., ineffective controls often require more focused substantive procedures that are performed closer to the balance-sheet date).

We plan to perform certain audit procedures on specific risks during the interim process; we audit and analyze significant and complex transactions or adoption of new accounting pronouncements as they occur. Further, we perform interim substantive audit procedures on financial statement line items without any identified risks and a portion of our testing of the design and operating effectiveness of relevant controls. We update those procedures and tests at year-end.

Perform

The performance of audit procedures, in accordance with applicable standards and consistent with this audit plan, will be based on the anticipated timing outlined in Appendix 3. The performance of the audit plan includes evaluating the design and testing the operating effectiveness of controls, and performing substantive audit procedures.

Perform Substantive Audit Procedures

Our substantive audit procedures consist of a tailored combination of analytical procedures and detail tests of transactions and balances; these procedures are designed to obtain reasonable assurance that the consolidated financial statements are free from material misstatements. To obtain reasonable assurance that the consolidated financial statements are free from material misstatements, we accumulate known and likely misstatements identified while performing substantive auditing procedures and consider such misstatements in relation to the consolidated financial statements taken as a whole. Misstatements that are identified will be reported to management and the Audit Committee.

Whenever possible, we will perform tests of internal controls and substantive tests concurrently. For example, in testing controls over fixed assets, we will select a sample appropriate for testing relevant controls and for performing the necessary level of substantive audit procedures in accordance with applicable standards.

Fraud-Related Procedures

In response to Statement on Auditing Standard (“SAS”) No. 99, *Consideration of Fraud in a Financial Statement Audit*, and continued emphasis on the auditor’s responsibility to uncover fraud during an audit, we will perform audit procedures to address fraud risks present at PPH. Our enhanced auditing procedures related to fraud include evaluating the design, implementation, and operating effectiveness of management’s processes for identifying and responding to the risk of material misstatement due to fraud, including programs and controls that management has established to mitigate that risk. Specifically, we will assess PPH’s formal fraud risk assessment in which management documents and engages in fraud brainstorming sessions, identifies potential fraud schemes inherent to PPH or the related industry, and links potential fraud schemes to PPH’s mitigating controls.

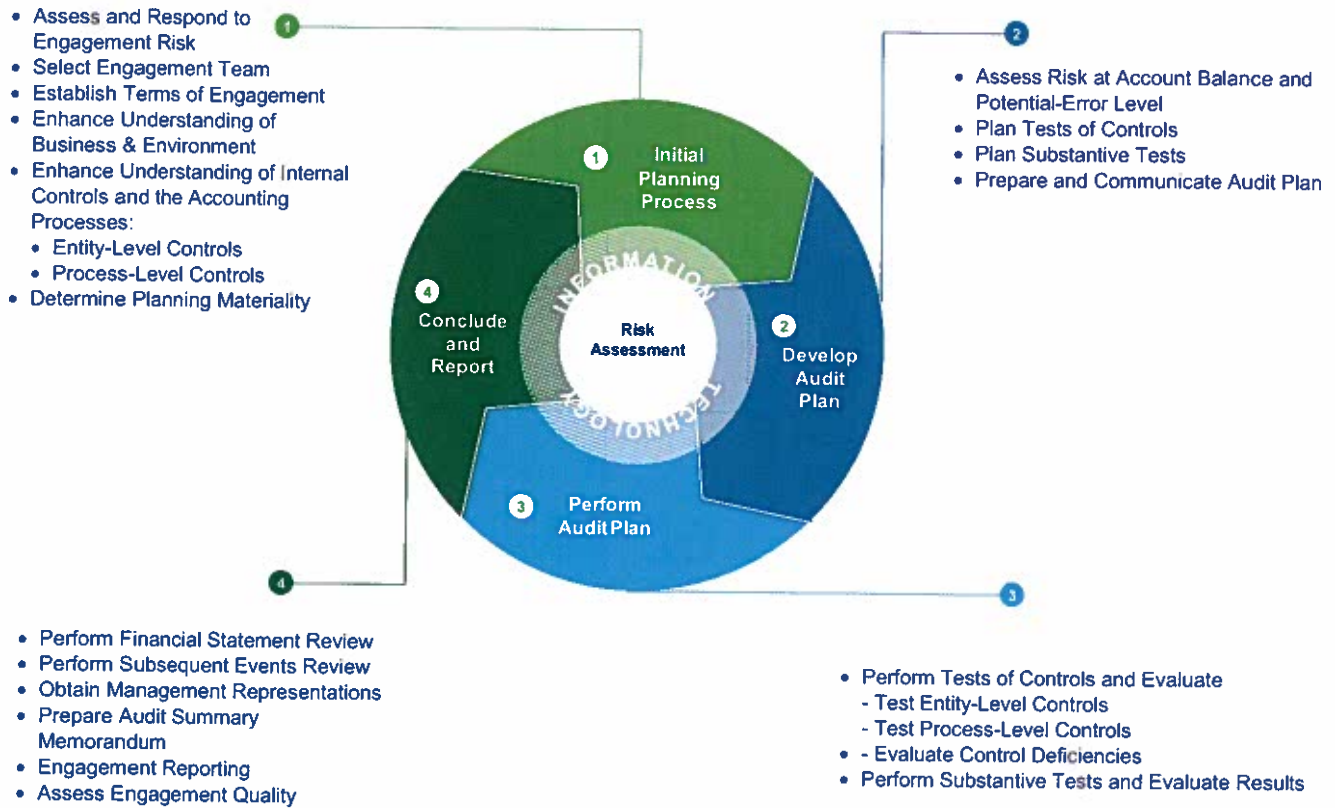
Conclude

The results of the auditing procedures performed will be analyzed and conclusions drawn based on the applicable standards. Prior to rendering our reports, we conclude whether the scope of the audit was sufficient to support our opinion and whether the misstatements identified, if any, cause the financial statements to be materially misstated.

Independence

Deloitte is committed to the highest standards of professional ethics, including compliance with all rules of the American Institute of Certified Public Accountants (“AICPA”) and the California State Board of Accountancy with respect to independence and the confidentiality of client information. Our professionals are also bound by the firm’s and the profession’s Code of Professional Conduct, which governs the manner in which we serve clients. We will report to you any relationships between PPH and our firm that may be reasonably thought to bear on our independence.

Appendix 1—Audit Approach Flowchart



Appendix 2—Our Service Team

The quality of professional services provided to PPH is dependent upon the individuals responsible for the delivery of those services. We are committed to serving PPH with professionals who understand the business needs of PPH and the environment in which PPH operates.

Our client service team includes individuals with extensive experience in the healthcare industry. These individuals provide a combination of many years of experience serving PPH or similar organizations and new perspective. This experience and familiarity with PPH’s operations and personnel help us perform our audit more efficiently and effectively.

		Years Serving PPH
Our engagement team is led by the following individuals:		
Mark Kawauchi	Audit Director	3 rd
Vicki Keiser	Engagement Quality Assurance Reviewer	2 nd
Jason Emmons	Enterprise Risk Services (“ERS”) Director	5 th
Lisa Biggs	Audit Senior Manager	3 rd
Shibani Dogra	Audit Manager	2 nd
Mark Wiesbrock	ERS Manager	2 nd
Julie Nguyen	Audit Senior Accountant	1 st

Appendix 3—Audit Timing

Audit Planning and Interim Field Work	
Discussions with key management personnel	April – June
Scope meeting with Audit Committee	July
Risk assessment and development of audit plan	May/June
Planning and testing of certain key audit areas	June /July
Evaluation and testing of internal accounting controls	June/July
Resolution of interim audit findings	July
Final Audit Work	
Complete substantive tests of accounts	August/September
Resolution of any remaining audit findings	August/September
Review drafts of financial statements	August/September
Report to the Audit Committee	October

Appendix 4—Communications to the Audit Committee

The following represents a summary of communications that external auditors are required to make, or determine that management has made, to audit committees. These requirements were promulgated by the American Institute of Certified Public Accountants and Deloitte policy and the required communications are consistent with our prior communications to PPH's Audit Committee.

- Our responsibility under auditing standards generally accepted in the United States of America
- Significant accounting policies and unusual transactions, including changes to, and initial selection of, accounting policies during the current year
- Critical accounting policies and practices
- Alternative treatments within generally accepted accounting principles ("GAAP") for accounting policies and practices related to material items that have been discussed with management
- Our judgments about the quality, not just the acceptability, of PPH's accounting policies as applied in its financial reporting
- Management judgments and sensitive accounting estimates
- Audit adjustments
 - Audit adjustments that have a significant effect on the financial reporting process, whether or not recorded by the organization
 - Proposed adjustments (uncorrected misstatements)
- Disagreements with management
- Management's consultation with other accountants about auditing and accounting matters
- Significant issues discussed or subject to correspondence with management prior to retention
- Difficulties encountered in dealing with management when performing the audit
- Responsibility for other information in documents containing audited financial statements
- Material written communications between Deloitte and management
- Management's representations to Deloitte upon completion of the audit
- Control-related matters
 - Identification of deficiencies, significant deficiencies and/or material weakness, if any
- Significant errors, irregularities, and illegal acts

Appendix 5—Engagement Letter



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USA

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June 30, 2009

Ms. Linda Greer
Chair of the Audit Committee of Palomar Pomerado Health
456 E. Grand Avenue
Escondido, CA 92025

Mr. Robert Hemker
Chief Financial Officer
Palomar Pomerado Health
456 E. Grand Avenue
Escondido, CA 92025

Dear Ms. Greer and Mr. Hemker:

Deloitte & Touche LLP ("D&T" or "we" or "us") is pleased to serve as independent auditors for Palomar Pomerado Health ("PPH"). Mr. Mark Kawauchi, Director, will be responsible for the services that we perform for PPH hereunder.

In addition to the audit services we are engaged to provide under this engagement letter, we would also be pleased to assist PPH on issues as they arise throughout the year. Hence, we hope that you will call Mr. Kawauchi whenever you believe D&T can be of assistance.

The services to be performed by D&T pursuant to this engagement are subject to the terms and conditions set forth herein and in the accompanying appendices. Such terms and conditions shall be effective as of the date of the commencement of such services.

Audit of Financial Statements

Our engagement is to perform an audit in accordance with auditing standards generally accepted in the United States of America ("generally accepted auditing standards"). The objective of an audit conducted in accordance with generally accepted auditing standards is to express an opinion on the fairness of the presentation of PPH's financial statements for the year ending June 30, 2009, in conformity with accounting principles generally accepted in the United States of America ("generally accepted accounting principles"), in all material respects.

Appendix A contains a description of our responsibilities and an audit under generally accepted auditing standards.

Our ability to express an opinion and the wording thereof will, of course, be dependent on the facts and circumstances at the date of our report. If, for any reason, we are unable to complete the audit or are unable to form or have not formed an opinion, we may decline to express an opinion or decline to issue a report as a result of this engagement. If we are unable to complete our audit or if the report to be issued by D&T as a result of this engagement requires modification, the reasons therefor will be discussed with the Audit Committee and PPH's management.

Management's Responsibilities

Appendix B describes management's responsibilities for (1) the financial statements, (2) representation letters, (3) process for obtaining preapproval of services, (4) independence matters relating to providing certain services, and (5) independence matters relating to hiring.

Responsibility of the Audit Committee

As independent auditors of PPH, we acknowledge that the Audit Committee is directly responsible for the appointment, compensation, and oversight of our work, and accordingly, except as otherwise specifically noted, we will report directly to the Audit Committee. You have advised us that the services to be performed under this engagement letter, including, where applicable, the use by D&T of affiliates or related entities as subcontractors in connection with this engagement, have been approved by the Audit Committee in accordance with the Audit Committee's established preapproval policies and procedures.

Communications with the Audit Committee

Appendix C describes various matters that we are required by generally accepted auditing standards to communicate with the Audit Committee and management.

Fees

We estimate that our fees for the audit of PPH's 2009 financial statements will be \$291,000, plus expenses. Based on the anticipated timing of the work, our fees will be billed approximately as follows:

Invoice Date	Amount
June 2009	\$60,000
July 2009	\$60,000
August 2009	\$70,000
September 2009	\$55,000
October 2009	\$46,000

We anticipate sending invoices according to the schedule above, and payments are due upon receipt. Engagement-related expenses, such as travel and report production, will be billed in addition to the fees. Expenses will be stated separately on the invoices.

Our continued service on this engagement is dependent upon payment of our invoices in accordance with these terms. To the extent that certain circumstances, as listed in Appendix D, arise during this engagement, our fee estimate also may be significantly affected, and additional fees may be necessary. We will notify you promptly of any circumstances we encounter that could significantly affect our estimate and discuss with you any additional fees, as necessary. Additional services provided beyond the scope of services described herein will be billed separately.

In addition, PPH agrees to compensate D&T for any time and expenses that we may incur in responding to requests for documents or information under the Health Insurance Portability and Accountability Act of 1996 ("HIPAA") and any regulations promulgated thereunder.

Inclusion of D&T Reports or References to D&T in Other Documents or Electronic Sites

If PPH intends to publish or otherwise reproduce in any document our report on PPH's financial statements, or otherwise make reference to D&T in a document that contains other information in addition to the audited financial statements (e.g., in a periodic filing with a regulator, in a debt or equity offering circular, or in a private placement memorandum), thereby associating D&T with such document, PPH agrees that its management will provide D&T with a draft of the document to read and obtain our approval for the inclusion or incorporation by reference of our report, or the reference to D&T, in such document before the document is printed and distributed. The inclusion or incorporation by reference of our report in any such document would constitute the reissuance of our report. PPH also agrees that its management will notify us and obtain our approval prior to including our report on an electronic site.

Our engagement to perform the services described herein does not constitute our agreement to be associated with any such documents published or reproduced by or on behalf of PPH. Any request by PPH to reissue our report, to consent to its inclusion or incorporation by reference in an offering or other document, or to agree to its inclusion on an electronic site will be considered based on the facts and circumstances existing at the time of such request. The estimated fees outlined herein do not include any services that would need to be performed in connection with any such request; fees for such services (and their scope) would be subject to the mutual agreement of PPH and D&T at such time as D&T is engaged to perform the services and would be described in a separate engagement letter.

* * * * *

This engagement letter, including the appendices attached hereto and made a part hereof, constitutes the entire agreement between the parties with respect to this engagement and supersedes all other prior and contemporaneous agreements or understandings between the parties, whether written or oral, relating to this engagement.

If the above terms are acceptable and the services outlined are in accordance with your understanding, please sign the copy of this engagement letter in the space provided and return it to us.

Yours truly,

Deloitte & Touche LLP

Acknowledged and approved on behalf of
The Audit Committee of Palomar Pomerado Health:

By: _____

Title: _____

Date: _____

Accepted and agreed to by Palomar Pomerado Health:

By: _____

Title: _____

Date: _____

**DESCRIPTION OF OUR RESPONSIBILITIES AND AN AUDIT UNDER GENERALLY ACCEPTED
AUDITING STANDARDS**

**Palomar Pomerado Health
Year Ending June 30, 2009**

Our Responsibilities

Our responsibilities under generally accepted auditing standards include forming and expressing an opinion about whether the financial statements that have been prepared by management with the oversight of the Audit Committee are presented fairly, in all material respects, in conformity with generally accepted accounting principles. The audit of the financial statements does not relieve management or the Audit Committee of their responsibilities.

Components of an Audit

An audit includes the following:

- Obtaining an understanding of PPH and its environment, including internal control, sufficient to assess the risks of material misstatement of the financial statements and to design the nature, timing, and extent of further audit procedures
- Consideration of internal control over financial reporting, as a basis for designing audit procedures that are appropriate in the circumstances but not for the purpose of expressing an opinion on the effectiveness of PPH's internal control over financial reporting
- Examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements
- Inquiring directly of the Audit Committee regarding its views about the risks of fraud and whether the Audit Committee has knowledge of any fraud or suspected fraud affecting PPH
- Assessing the accounting principles used and significant estimates made by management
- Evaluating the overall financial statement presentation

Reasonable Assurance

We will plan and perform our audit to obtain reasonable assurance about whether the financial statements are free of material misstatement, whether caused by error or fraud. However, because of the characteristics of fraud, a properly planned and performed audit may not detect a material misstatement. Therefore, an audit conducted in accordance with generally accepted auditing standards is designed to obtain reasonable, rather than absolute, assurance that the financial statements are free of material misstatement. An audit is not designed to detect error or fraud that is immaterial to the financial statements, nor is it designed to provide assurance on internal control or to identify deficiencies in internal control.

Medicare, Medicaid and HIPAA Compliance

Claims for payment for services rendered to Medicare and Medicaid beneficiaries must meet applicable billing laws and regulations that, among other things, require that the services are medically necessary, accurately coded, and sufficiently documented in the beneficiaries' medical records. Although we will make certain limited inquiries about procedures and controls relating to compliance with these laws and regulations, we will not perform an audit of claims submitted to Medicare and Medicaid with respect to such compliance. The determination of medical necessity, coding accuracy, and sufficiency of medical records documentation is not within the auditors' responsibility. Accordingly, neither our audit of PPH's financial statements for the year ending June 30, 2009, nor any reviews or other services provided pursuant to this engagement letter, will provide any assurances, nor will we express any opinion, that the claims submitted by PPH for services rendered to Medicare and Medicaid beneficiaries are in compliance with applicable billing laws and regulations.

As described below, identifying and ensuring that PPH complies with the laws and regulations applicable to its activities is the responsibility of PPH's management. Neither our audit of PPH's financial statements for the year ending June 30, 2009, nor any reviews or other services provided pursuant to this engagement letter will provide any assurances, nor will we express any opinion, that PPH's efforts or the efforts of any other parties, such as PPH's vendors, service providers, customers, unconsolidated subsidiaries or joint ventures in which PPH has an investment, or other third parties are appropriate to establish procedures or to have a process in place to be compliant with the laws and regulations of HIPAA or any other laws or regulations. In addition, we are not engaged to perform, nor will we perform as part of this engagement, any procedures to test whether PPH is compliant with HIPAA or any other laws or regulations, or whether the plans and activities of PPH or any other third parties are sufficient to address and correct problems that might arise because of noncompliance, nor will we express any opinion or provide any other assurances with respect to these matters.

MANAGEMENT'S RESPONSIBILITIES

**Palomar Pomerado Health
Year Ending June 30, 2009**

Financial Statements

The overall accuracy of the financial statements and their conformity with generally accepted accounting principles are the responsibility of PPH's management. In this regard, management has the responsibility for, among other things:

- Selecting and applying the accounting policies
- Establishing and maintaining effective internal control over financial reporting
- Designing and implementing programs and controls to prevent and detect fraud
- Identifying and ensuring that PPH complies with the laws and regulations applicable to its activities and informing us of any known material violations of such laws or regulations
- Adjusting the financial statements to correct material misstatements
- Making all financial records and related information available to us.

Representation Letters

We will make specific inquiries of PPH's management about the representations embodied in the financial statements. Additionally, we will request that management provide to us the written representations PPH is required to provide to its independent auditors under generally accepted auditing standards. As part of our audit procedures, we will request that management provide us with a representation letter that includes, among other things:

- Acknowledgment of management's responsibility for the preparation of the financial statements
- Affirmation of management's belief that the effects of any uncorrected financial statement misstatements aggregated by us during the current audit engagement and pertaining to the latest period presented are immaterial, both individually and in the aggregate, to the financial statements taken as a whole.

We will also request that management confirm certain representations made to us during our audit. The responses to those inquiries and related written representations of management required by generally accepted auditing standards are part of the evidential matter that D&T will rely on in forming its opinion on PPH's financial statements. Because of the importance of management's representations, PPH agrees to release and indemnify D&T, its subcontractors, and their respective personnel from all claims, liabilities, and expenses relating to our services under this engagement letter attributable to any misrepresentation by management.

Process for Obtaining Preapproval of Services

Management is responsible for the coordination of obtaining the preapproval of the Audit Committee, in accordance with the Audit Committee's preapproval process, for any services to be provided by D&T to PPH.

Independence Matters Relating to Providing Certain Services

In connection with our engagement, D&T, management, and the Audit Committee will assume certain roles and responsibilities in an effort to assist D&T in maintaining independence. Management of PPH will ensure that PPH has policies and procedures in place for the purpose of ensuring that PPH will not act to engage D&T or accept from D&T any service that under American Institute of Certified Public Accountants (“AICPA”) or other applicable rules would impair D&T’s independence. All potential services are to be discussed with Mr. Kawauchi.

Independence Matters Relating to Hiring

Management will coordinate with D&T to ensure that D&T’s independence is not impaired by hiring former or current D&T partners, principals, or professional employees in a key position, as defined in the AICPA *Code of Professional Conduct*, that would cause a violation of the AICPA *Code of Professional Conduct* or other applicable independence rules. Any employment opportunities with PPH for a former or current D&T partner, principal, or professional employee should be discussed with Mr. Kawauchi before entering into substantive employment conversations with the former or current D&T partner, principal, or professional employee.

For purposes of the preceding two paragraphs, “D&T” shall mean Deloitte & Touche LLP and its subsidiaries; Deloitte Touche Tohmatsu, its member firms, the affiliates of Deloitte & Touche LLP, Deloitte Touche Tohmatsu, and its member firms; and, in all cases, any successor or assignee.

COMMUNICATIONS WITH THE AUDIT COMMITTEE

**Palomar Pomerado Health
Year Ending June 30, 2009**

Significant Matters

We are responsible for communicating significant matters related to the audit that are, in our professional judgment, relevant to the responsibilities of the Audit Committee in overseeing the financial reporting process.

Fraud and Illegal Acts

We will report directly to the Audit Committee any fraud of which we become aware that involves senior management and any fraud (whether caused by senior management or other employees) of which we become aware that causes a material misstatement of the financial statements. We will report to senior management any fraud perpetrated by lower-level employees of which we become aware that does not cause a material misstatement of the financial statements; however, we will not report such matters directly to the Audit Committee, unless otherwise directed by the Audit Committee.

We will inform the appropriate level of management of PPH and determine that the Audit Committee is adequately informed with respect to illegal acts that have been detected or have otherwise come to our attention in the course of our audit, unless the illegal acts are clearly inconsequential.

Internal Control Matters

We will report directly to management and the Audit Committee all significant deficiencies and material weaknesses identified during the audit as required by AICPA AU 325, *Communicating Internal Control Related Matters Identified in an Audit*. Our written communication will identify those matters considered by D&T to be significant deficiencies and those that are considered by D&T to be material weaknesses.

A significant deficiency is a deficiency, or a combination of deficiencies, in internal control that is less severe than a material weakness, yet important enough to merit attention by those charged with governance. A material weakness is a deficiency, or combination of deficiencies, in internal control, such that there is a reasonable possibility that a material misstatement of PPH's financial statements will not be prevented, or detected and corrected on a timely basis.

Other Matters

Generally accepted auditing standards do not require us to design procedures for the purpose of identifying other matters to communicate with the Audit Committee. However, we will communicate to the Audit Committee matters required by AICPA AU 380, *The Auditor's Communication With Those Charged With Governance*.

**CIRCUMSTANCES AFFECTING TIMING AND FEE ESTIMATE
Palomar Pomerado Health
Year Ending June 30, 2009**

The fees quoted for the audit are based on certain assumptions. Circumstances may arise during the engagement that may significantly affect the targeted completion dates or our fee estimate. As a result, changes to the fees may be necessary. Such circumstances include but are not limited to the following:

Audit Facilitation

1. Changes to the timing of the engagement at PPH's request. Changes to the timing of the engagement usually require reassignment of personnel used by D&T in the performance of services hereunder. However, because it is often difficult to reassign individuals to other engagements, D&T may incur significant unanticipated costs.
2. All audit schedules are not (a) provided by PPH on the date requested, (b) completed in a format acceptable to D&T, (c) mathematically correct, or (d) in agreement with the appropriate PPH records (e.g., general ledger accounts). D&T will provide PPH with a separate listing of required schedules, information requests, and the dates such items are needed.
3. Significant delays in responding to our requests for information, such as reconciling variances or providing requested supporting documentation (e.g., invoices, contracts, and other documents).
4. Deterioration in the quality of PPH's accounting records during the current-year engagement in comparison with the prior-year engagement.
5. A completed trial balance, referenced to the supporting analyses and schedules and financial statements, is not provided timely by PPH's personnel.
6. Draft financial statements with appropriate supporting documentation are not prepared accurately and timely by PPH's personnel.
7. Electronic files in an appropriate format and containing the information requested are not provided by PPH on the date requested for our use in performing file interrogation. D&T will provide PPH with a separate listing of the required files and the dates the files are needed.
8. The engagement team, while performing work on PPH's premises, is not provided with high-speed access to the Internet via PPH's existing network or through a T1, DSL, or cable connection for purposes of conducting the engagement.

Significant Issues or Changes

9. Significant deficiencies or material weaknesses in the design or operating effectiveness of PPH's internal control over financial reporting are identified during our audit that result in the expansion of our audit procedures.
10. A significant level of proposed audit adjustments is identified during our audit.

11. A significant number of drafts of the financial statements are submitted for our review, or we identify a significant level of deficiencies in the draft financial statements.
12. Significant new issues or changes as follows:
 - a. Significant new accounting issues.
 - b. Significant changes in accounting policies or practices from those used in prior years.
 - c. Significant events or transactions not contemplated in our budgets.
 - d. Significant changes in PPH's financial reporting process or Information Technology systems.
 - e. Significant changes in PPH's accounting personnel, their responsibilities, or their availability.
 - f. Significant changes in auditing standards.
 - g. Significant changes in PPH's use of specialists, or the specialists or their work product does not meet the qualifications required by generally accepted auditing standards for our reliance upon their work.
13. Changes in audit scope caused by events that are beyond our control.

Payment for Services Rendered

14. Without limiting its rights or remedies, D&T may halt or terminate its services entirely if payment is not received within 30 days of the date of the invoice.

APPENDIX E

GENERAL BUSINESS TERMS

Palomar Pomerado Health
Year Ending June 30, 2009

1. Independent Contractor. It is understood and agreed that D&T is an independent contractor and that D&T is not, and will not be considered to be, an agent, partner, fiduciary, or representative of PPH or the Audit Committee.
2. Survival. The agreements and undertakings of PPH and the Audit Committee contained in the engagement letter to which these terms are attached (the "engagement letter"), together with the appendices to the engagement letter including these terms, will survive the completion or termination of this engagement.
3. Assignment and Subcontracting. Except as provided below, no party may assign, transfer, or delegate any of its rights or obligations relating to this engagement (including, without limitation, interests or claims relating to this engagement) without the prior written consent of the other parties. PPH and the Audit Committee hereby consent to D&T subcontracting a portion of its services under this engagement to any affiliate or related entity, whether located within or outside of the United States. Professional services performed hereunder by any of D&T's affiliates or related entities shall be invoiced as professional fees, and any related expenses shall be invoiced as expenses, unless otherwise agreed.
4. Severability. If any term of the engagement letter, including its appendices, is determined to be invalid or unenforceable, such term shall not affect the other terms hereof or thereof, but such invalid or unenforceable term shall be deemed modified to the extent necessary to render it enforceable, preserving to the fullest extent permissible the intent of the parties set forth herein and therein.
5. Force Majeure. No party shall be deemed to be in breach of the engagement letter (including its appendices) as a result of any delays or non-performance directly or indirectly resulting from circumstances or causes beyond its reasonable control, including, without limitation, fire, epidemic or other casualty, act of God, strike or labor dispute, war or other violence, or any law, order or requirement of any governmental agency or authority.
6. Dispute Resolution. Any controversy or claim between the parties arising out of or relating to the engagement letter, including its appendices, or this engagement (a "Dispute") shall be resolved by mediation or binding arbitration as set forth in the Dispute Resolution Provision attached hereto as Appendix F and made a part hereof.

DISPUTE RESOLUTION PROVISION
Palomar Pomerado Health
Year Ending June 30, 2009

This Dispute Resolution Provision sets forth the dispute resolution process and procedures applicable to the resolution of Disputes and shall apply to the fullest extent of the law, whether in contract, statute, tort (such as *negligence*), or otherwise.

Mediation: All Disputes shall be first submitted to nonbinding confidential mediation by written notice to the parties, and shall be treated as compromise and settlement negotiations under the standards set forth in the Federal Rules of Evidence and all applicable state counterparts, together with any applicable statutes protecting the confidentiality of mediations or settlement discussions. If the parties cannot agree on a mediator, the International Institute for Conflict Prevention and Resolution ("CPR"), at the written request of a party, shall designate a mediator.

Arbitration Procedures: If a Dispute has not been resolved within 90 days after the effective date of the written notice beginning the mediation process (or such longer period, if the parties so agree in writing), the mediation shall terminate and the Dispute shall be settled by binding arbitration to be held in New York, New York. The arbitration shall be solely between the parties and shall be conducted in accordance with the CPR Rules for Non-Administered Arbitration that are in effect at the time of the commencement of the arbitration, except to the extent modified by this Dispute Resolution Provision (the "Rules").

The arbitration shall be conducted before a panel of three arbitrators. Each of PPH and Deloitte & Touche LLP shall designate one arbitrator in accordance with the "screened" appointment procedure provided in the Rules and the two party-designated arbitrators shall jointly select the third in accordance with the Rules. No arbitrator may serve on the panel unless he or she has agreed in writing to enforce the terms of the engagement letter (including its appendices) to which this Dispute Resolution Provision is attached and to abide by the terms of this Dispute Resolution Provision. Except with respect to the interpretation and enforcement of these arbitration procedures (which shall be governed by the Federal Arbitration Act), the arbitrators shall apply the laws of the State of New York (without giving effect to its choice of law principles) in connection with the Dispute. The arbitrators shall have no power to award punitive, exemplary or other damages not based on a party's actual damages (and the parties expressly waive their right to receive such damages). The arbitrators may render a summary disposition relative to all or some of the issues, provided that the responding party has had an adequate opportunity to respond to any such application for such disposition. Discovery shall be conducted in accordance with the Rules.

All aspects of the arbitration shall be treated as confidential, as provided in the Rules. Before making any disclosure permitted by the Rules, a party shall give written notice to all other parties and afford such parties a reasonable opportunity to protect their interests. Further, judgment on the arbitrators' award may be entered in any court having jurisdiction.

Costs: Each party shall bear its own costs in both the mediation and the arbitration; however, the parties shall share the fees and expenses of both the mediators and the arbitrators equally.

**BUSINESS ASSOCIATE INDEX
Palomar Pomerado Health
Year Ending June 30, 2009**

If and to the extent, and so long as, required by 42 U.S.C. §§ 1320d through 1320d-8 and the regulations issued thereunder ("HIPAA") and not otherwise, Deloitte & Touche LLP ("D&T") and Palomar Pomerado Health ("PPH") hereby agree to the following with respect to Protected Health Information (as such term is defined in 45 CFR § 160.103) of PPH obtained by D&T in connection with its performance of services under the attached engagement letter (such engagement letter, together with all attachments, appendices, and exhibits thereto, including this Business Associate Appendix, this "Agreement"):

- (A) D&T may use and disclose such Protected Health Information as reasonably required or contemplated in connection with the performance of services under this Agreement, excluding the use or further disclosure of such Protected Health Information in a manner that would violate the requirements of 45 CFR Part 164, if done by PPH; provided, however, D&T may use and disclose such Protected Health Information for the proper management and administration of D&T as provided in 45 CFR § 164.504(e)(4), including without limitation use and disclosure as required for D&T to comply with applicable professional standards and obligations;
- (B) D&T will not use or further disclose such Protected Health Information other than as permitted or required by this Agreement or as required by applicable law;
- (C) D&T will use appropriate safeguards to prevent use or disclosure of such Protected Health Information other than as provided for by this Agreement;
- (D) D&T will report to PPH any use or disclosure of such Protected Health Information not provided for by this Agreement of which D&T becomes aware;
- (E) D&T will ensure that any subcontractors or agents to whom D&T provides such Protected Health Information agree to the same restrictions and conditions that apply to D&T with respect to such Protected Health Information;
- (F) D&T will make available such Protected Health Information in accordance with 45 CFR §164.524;
- (G) D&T will make available such Protected Health Information for amendment and incorporate any amendments to such information in accordance with 45 CFR §164.526;
- (H) D&T will make available the information required to provide an accounting of disclosures in accordance with 45 CFR §164.528;
- (I) D&T will make its internal practices, books, and records relating to the use and disclosure of such Protected Health Information available to the United States Health and Human Services Secretary for purposes of determining PPH's compliance with 45 CFR Part 164;
- (J) D&T will, at termination of this Agreement, if feasible, return or destroy all such Protected Health Information that D&T still maintains in any form and retain no copies of such Protected Health Information or, if such return or destruction is not feasible (such as in the event that the retention of such Protected Health Information by D&T is required by law, regulation, professional standards, or reasonable business practice to evidence D&T's services), extend the protections of this Business Associate Appendix to such Protected Health Information and limit further uses and disclosures to those purposes that make the return or destruction of such Protected Health Information infeasible;

- (K) PPH will have the right to terminate this Agreement by the delivery of written notice of termination to D&T if PPH determines that D&T has violated a material term of this Business Associate Appendix and D&T fails to cure such violation within 30 days of D&T's receipt of written notice of such violation;
- (L) PPH will not disclose any Protected Health Information or other information to D&T, if such disclosure would violate HIPAA or any applicable state law;
- (M) PPH has not adopted and will not adopt any privacy policies that would restrict D&T's ability to provide services contemplated under this Agreement or otherwise restrict D&T's ability to use and disclose Protected Health Information for the proper management and administration of D&T as permitted under this Agreement;
- (N) PPH has not sought any patient consents or authorizations or agreed to any restrictions requested by patients, and will not seek any patient consents or authorizations or agree to any such restrictions in the future, that would restrict D&T's ability to provide services contemplated under this Agreement or otherwise restrict D&T's ability to use and disclose Protected Health Information for the proper management and administration of D&T as permitted under this Agreement;
- (O) Without limiting clause (M) above, PPH shall provide D&T with a copy of its Notice of Privacy Practices ("Notice") currently in use and if such Notice is modified in the future, PPH shall provide D&T with such modified Notice promptly following adoption;
- (P) Without limiting clause (N) above, PPH shall notify D&T of any change in, or the withdrawal of, the consent or authorization of an individual regarding the use or disclosure of Protected Health Information to the extent that such change or withdrawal may affect D&T's use or disclosure of Protected Health Information;
- (Q) PPH shall not request D&T to use or disclose Protected Health Information in any manner that would not be permissible under HIPAA if done by PPH;
- (R) Nothing contained in this Business Associate Appendix is intended to confer upon any person (other than the parties hereto) any rights, benefits, or remedies of any kind or character whatsoever, whether in contract, statute, tort (such as negligence), or otherwise, and no person shall be deemed a third-party beneficiary under or by reason of this Business Associate Appendix; and
- (S) Effective on and after April 20, 2005 (or April 20, 2006 if PPH is a small health plan, as defined in 45 CFR § 160.103), D&T will:
 - a. implement administrative, physical, and technical safeguards that reasonably and appropriately protect the confidentiality, integrity, and availability of the electronic Protected Health Information that it creates, receives, maintains or transmits on behalf of PPH in connection with this Agreement;
 - b. ensure that any agent, including a subcontractor, to whom it provides such electronic Protected Health Information agrees to implement reasonable and appropriate safeguards to protect it; and
 - c. report to PPH any attempted or successful unauthorized access, use, disclosure, modification, or destruction of such electronic Protected Health Information or interference with system operations in an Information System (as defined in 45 CFR § 164.304) affecting such electronic Protected Health Information of which D&T becomes aware.

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Palomar Pomerado Health

**A Practical Guide for Audit
Committees**

Checklists and Tools

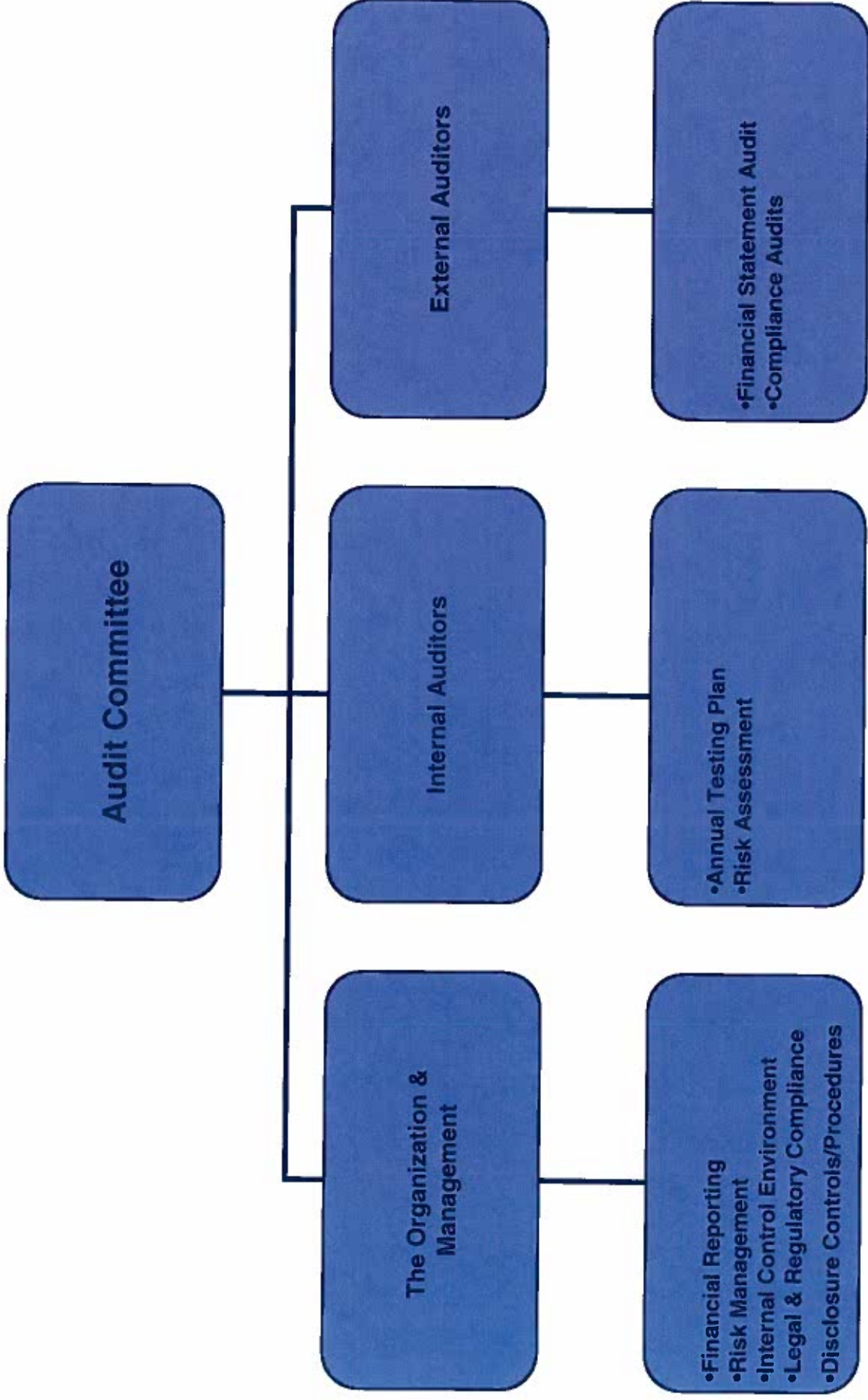
July 21, 2009

Role of the Audit Committee

What is the Audit Committee's role in governance?

- The Audit Committee should provide oversight of financial reporting, risk management, internal control, legal and regulatory compliance, disclosure controls and procedures, ethics and independence, financial statement audits, internal auditors, and the external auditors.
- It is the Audit Committee's responsibility to monitor tone-at-the-top as well as oversee the organization's ethical environment and compliance with laws and regulations.
- The Audit Committee also should ensure the financial leadership team is well-qualified and competent and succession planning issues are addressed.

Role of the Audit Committee (Continued)



Audit Committee Tools and Checklists

- **Sample Audit Committee Charter**
- **Planning Tool: Audit Committee Calendar of Activities**
- **Audit Committee AICPA Self Evaluation**
- **Basic Financial Literacy Self Assessment Tool**
- **The Center for Corporate Governance**

Sample Audit Committee Charter

Source: IIA Audit Committee: Purpose, Process, Professionalism



Sample Audit Committee Charter

Excerpt from the Audit Committee Resource Guide

This sample audit committee charter is based on a review of selected Fortune 1000 company charters, as well as the requirements of the Sarbanes-Oxley Act of 2002 and the NYSE and NASDAQ corporate-governance listing standards. It contains general information only and does not constitute, and should not be regarded as, legal or similar professional advice. This charter is not a substitute for such professional advice, nor should it be used as a basis for any decision or action that may affect you or your business. Any such decision or action should be taken only upon the advice of a qualified professional advisor. This charter was prepared based on information available as of June 21, 2006, and is subject to change if additional guidance is issued by the SEC, NYSE, or NASDAQ. Neither Deloitte & Touche LLP nor any of its affiliates or related entities have any liability or responsibility to any person or entity with respect to their use of or reliance on this charter. All companies should consult with legal counsel regarding the applicability and implementation of the various requirements identified. This template is designed for U.S. public companies; exceptions to the requirements noted below may apply for certain issuers, including investment companies, small-business issuers, and foreign private issuers. Many of the items presented here are not applicable to voluntary filers. All companies should consult with legal counsel regarding the applicability and implementation of the various requirements identified.

Audit Committee of the Board of Directors—Charter

I. Purpose

The audit committee is established by and among the board of directors for the primary purpose of assisting the board in:

- Overseeing the integrity of the company's financial statements **[NYSE Corporate Governance Rule 7(c)(f)(A)]** and the company's accounting and financial reporting processes and financial statement audits **[NASDAQ Corporate Governance Rule 4350(d)(1)]**
- Overseeing the company's compliance with legal and regulatory requirements **[NYSE Corporate Governance Rule 7(c)(f)(A)]**
- Overseeing the registered public accounting firm's (independent auditor's) qualifications and independence **[NYSE Corporate Governance Rule 7(c)(f)(A) and NASDAQ Corporate Governance Rule 4350(d)(1)(c)]**
- Overseeing the performance of the company's independent auditor **[NYSE Corporate Governance Rule 7(c)(f)(A) and NASDAQ Corporate Governance Rule 4350(d)(1)]** and internal audit function **[NYSE Corporate Governance Rule 7(c)(f)(A)]**
- Overseeing the company's systems of disclosure controls and procedures, internal controls over financial reporting, and compliance with ethical standards adopted by the company.

Consistent with this function, the audit committee should encourage continuous improvement of, and should foster adherence to, the company's policies, procedures, and practices at all levels. The audit committee should also provide for open communication among the independent auditor, financial and senior management, the internal audit function, and the board of directors.

The audit committee has the authority to obtain advice and assistance from outside legal, accounting, or other advisors as necessary to perform its duties and responsibilities **[Sarbanes-Oxley Act Section 301, NYSE Corporate Governance Rule 6, and NASDAQ Corporate Governance Rule 4350(d)(3)]**.

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The company will provide appropriate funding, as determined by the audit committee, for compensation to the independent auditor, to any advisors that the audit committee chooses to engage, and for payment of ordinary administrative expenses of the audit committee that are necessary or appropriate in carrying out its duties. **[Sarbanes-Oxley Act Section 301, NYSE Corporate Governance Rule 6, and NASDAQ Corporate Governance Rule 4350(d)(3)].**

The audit committee will primarily fulfill its responsibilities by carrying out the activities enumerated in Section III of this charter. The audit committee will report regularly to the board of directors regarding the execution of its duties and responsibilities **[NYSE Corporate Governance Rule 7(c)(iii)(H)].**

II. Composition and Meetings¹

The audit committee will comprise three or more directors as determined by the board. Each audit committee member will meet the applicable standards of independence and the determination of independence will be made by the board **[Sarbanes-Oxley Act Section 301, NYSE Corporate Governance Rules 6 and 7(a) and (b), and NASDAQ Corporate Governance Rule 4350(d)(2)].**

All members of the committee must comply with all financial-literacy requirements of the securities exchange(s) on which the company is listed. At least one member will qualify as an "audit committee financial expert" as defined by the SEC and determined by the board **[Sarbanes-Oxley Act Section 407]**.²

The members of the committee will be appointed by the board at the annual organizational meeting of the board to serve until their successors are elected. Unless a chairperson is elected by the full board, the members of the committee may designate a chairperson by majority vote.

The committee will meet at least quarterly, or more frequently as circumstances dictate. The committee chairperson will approve the agenda for the committee's meetings and any member may suggest items for consideration. Briefing materials will be provided to the committee as far in advance of meetings as practicable. Each regularly scheduled meeting will conclude with an executive session of the committee absent members of management. As part of its responsibility to foster open communication, the committee will meet periodically with management, the director of the internal audit function, and the independent auditor in separate executive sessions **[NYSE Corporate Governance Rule 7(c)(iii)(E)]**. In addition, the committee will meet with the independent auditor and management to discuss the annual audited financial statements and quarterly financial statements, including the company's disclosures under "Management's Discussion and Analysis of Financial Condition and Results of Operations" **[NYSE Corporate Governance Rule 7(c)(iii)(B)]**.

III. Responsibilities and Duties

To fulfill its responsibilities and duties, the audit committee will:

Documents/Reports/Accounting Information Review

1. Review this charter at least annually and recommend to the board of directors any necessary amendments **[NYSE Corporate Governance Rules and NASDAQ Corporate Governance Rule 4350(d)(1)].**

¹Consideration also should be given to the amount of time members of the audit committee can devote to the role. Although there are no limits on the number of public-company audit committees on which an individual may serve, the NYSE states in the commentary to Corporate Governance Rule 7: "...if an audit committee member simultaneously serves on the audit committee of more than three public companies...the board must determine that such simultaneous service would not impair the ability of such member to effectively serve on the listed company's audit committee and disclose such determination in the annual proxy statement."

²A company is not required to have an audit committee financial expert, but the existence of at least one audit committee financial expert on the board is a common practice. A director who satisfies the criteria for an audit committee financial expert is presumed to satisfy the heightened financial literacy required of one member of the committee by the NYSE and NASDAQ, if a company has more than one audit committee financial expert, the rules allow the company to decide whether to disclose the existence and names of other individuals who qualify. If the board determines there is no audit committee financial expert on the audit committee, the company must disclose this fact in its applicable SEC filing and the reason why there is none.

2. Meet with management and the independent auditor to review and discuss the company's annual financial statements **[Item 306 of Regulation S-K]** and quarterly financial statements (prior to the company's Form 10-Q filings or release of earnings), as well as all internal control reports (or summaries thereof). Review other relevant reports or financial information submitted by the company to any governmental body or the public, including management certifications as required by the Sarbanes-Oxley Act of 2002 **[Sarbanes-Oxley Act Sections 302 and 906]** and relevant reports rendered by the independent auditor (or summaries thereof).
3. Recommend to the board whether the financial statements should be included in the annual report on Form 10-K **[Item 306 of Regulation S-K]**.
4. Discuss earnings press releases, including the type and presentation of information, paying particular attention to any pro forma or adjusted non-GAAP information. Such discussions may be in general terms (i.e., discussion of the types of information to be disclosed and the type of presentations to be made) **[NYSE Corporate Governance Rule 7(c)(iii)(C) and general commentary to Rule 7(c)]**.
5. Discuss financial information and earnings guidance provided to analysts and ratings agencies. Such discussions may be in general terms (i.e., discussion of the types of information to be disclosed and the type of presentations to be made) **[NYSE Corporate Governance Rule 7(c)(iii)(C) and general commentary to Rule 7(c)]**.
6. Review the regular internal reports to management (or summaries thereof) prepared by the internal audit function, as well as management's response.

Independent Auditor

7. Appoint (and recommend that the board submit for shareholder ratification, if applicable), compensate, retain, and oversee the work performed by the independent auditor for the purpose of preparing or issuing an audit report or related work. Review the performance and independence of the independent auditor and remove the independent auditor if circumstances warrant. The independent auditor will report directly to the audit committee and the audit committee will oversee the resolution of disagreements between management and the independent auditor if they arise **[Sarbanes-Oxley Act Section 301, NYSE Corporate Governance Rule 6, and NASDAQ Corporate Governance Rule 4350(d)(3)]**.
 8. Consider whether the auditor's provision of permissible nonaudit services is compatible with the auditor's independence. Discuss with the independent auditor the matters required to be discussed under Statement on Auditing Standards (SAS) No. 61, as amended by SAS No. 84 and SAS No. 90 **[Item 306 of Regulation S-K]**.
 9. Review with the independent auditor any problems or difficulties and management's response **[NYSE Corporate Governance Rule 7(c)(iii)(F)]**.
 10. Review the independent auditor's attestation and report on management's assessment of internal control over financial reporting **[Sarbanes-Oxley Act Section 404]**.
11. Hold timely discussions with the independent auditor regarding the following:
- All critical accounting policies and practices **[Sarbanes-Oxley Act Section 204]**
 - All alternative treatments of financial information within generally accepted accounting principles related to material items that have been discussed with management, ramifications of the use of such alternative disclosures and treatments, and the treatment preferred by the independent auditor **[Sarbanes-Oxley Act Section 204]**
 - Other material written communications between the independent auditor and management, including, but not limited to, the management letter and schedule of unadjusted differences **[Sarbanes-Oxley Act Section 204]**.

12. At least annually, obtain and review a report by the independent auditor describing:

- The independent auditor's internal quality-control procedures **[NYSE Corporate Governance Rule 7(c)(iii)(A)]**
- Any material issues raised by the most recent internal quality-control review or peer review, or by any inquiry or investigation conducted by governmental or professional authorities during the preceding five years with respect to independent audits carried out by the independent auditor, and any steps taken to deal with such issues **[NYSE Corporate Governance Rule 7(c)(iii)(A)]**
- All relationships between the independent auditor and the company **[NYSE Corporate Governance Rule 7(c)(iii)(A)]**, addressing the matters set forth in Independence Standards Board Standard No. 1 **[Item 306 of Regulation S-K]**.

This report should be used to evaluate the independent auditor's qualifications, performance, and independence. Further, the committee will review the experience and qualifications of the lead partner each year and determine that all partner rotation requirements, as promulgated by applicable rules and regulations, are executed. The committee will also consider whether there should be rotation of the independent auditor itself **[Commentary to NYSE Corporate Governance Rule 7(c)(iii)(A)]**.

13. Actively engage in dialogue with the independent auditor with respect to any disclosed relationships or services that may affect the independence and objectivity of the auditor and take appropriate actions to oversee the independence of the outside auditor **[NASDAQ Corporate Governance Rule 4350(d)(1)]**.
14. Review and preapprove (which may be pursuant to preapproval policies and procedures³) both audit and nonaudit services to be provided by the independent auditor. The authority to grant preapprovals may be delegated to one or more designated members of the audit committee, whose decisions will be presented to the full audit committee at its next regularly scheduled meeting **[Sarbanes-Oxley Act Section 202]**.
15. Set policies, consistent with governing laws and regulations, for hiring personnel of the independent auditor **[NYSE Corporate Governance Rule 7(c)(iii)(G)]**.⁴

Financial Reporting Processes, Accounting Policies, and Internal Control Structure

16. In consultation with the independent auditor and the internal audit function, review the integrity of the company's financial reporting processes (both internal and external), and the internal control structure (including disclosure controls and procedures and internal control over financial reporting).
17. Receive and review any disclosure from the company's CEO or CFO made in connection with the certification of the company's quarterly and annual reports filed with the SEC of: a) significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the company's ability to record, process, summarize, and report financial data; and b) any fraud, whether or not material, that involves management or other employees who have a significant role in the company's internal controls **[Sarbanes-Oxley Act Section 302]**.
18. Review major issues regarding accounting principles and financial statement presentations, including any significant changes in the company's selection or application of accounting principles; major issues as to the adequacy of the company's internal controls; and any special audit steps adopted in light of material control deficiencies **[General commentary to NYSE Corporate Governance Rule 7(c)]**.
19. Review analyses prepared by management (and the independent auditor as noted in item 11 above) setting forth significant financial reporting issues and judgments made in connection with the preparation of the financial statements, including analyses of the effects of alternative GAAP methods on the financial statements **[General commentary to NYSE Corporate Governance Rule 7(c)]**.

³ Any policy under which audit or nonaudit services are preapproved needs to be detailed as to the particular services and the audit committee needs to be informed of each service **[Regulation S-X, 2-01(c)(7)]**.

⁴ Such policy should take into consideration the one-year "cooling-off period" for individuals in a financial reporting oversight role, such as the CEO, CFO, controller, CAO, or the equivalent, as required by Section 206 of the Sarbanes-Oxley Act, as well as other prohibited relationships under the related rules of the SEC.

20. Review the effect of regulatory and accounting initiatives, as well as off-balance-sheet structures, on the financial statements of the company **[General commentary to NYSE Corporate Governance Rule 7(c)]**.

21. Review and approve all related-party transactions, defined as those transactions required to be disclosed under Item 404 of Regulation S-K **[NASDAQ Corporate Governance Rule 4350(h)]**.

22. Establish and oversee procedures for the receipt, retention, and treatment of complaints regarding accounting, internal accounting controls, or auditing matters, including procedures for confidential, anonymous submissions by company employees regarding questionable accounting or auditing matters **[Sarbanes-Oxley Act Section 301, NYSE Corporate Governance Rule 6, and NASDAQ Corporate Governance Rule 4350(d)(3)]**.

Internal Audit ⁵⁶

23. Review and advise on the selection and removal of the internal audit director.

24. Review the activities and organizational structure of the internal audit function, as well as the qualifications of its personnel.

25. Annually, review and recommend changes (if any) to the internal audit charter.

26. Periodically review, with the internal audit director, any significant difficulties, disagreements with management, or scope restrictions encountered in the course of the function's work.

27. Periodically review, with the independent auditor, the internal audit function's responsibility, budget, and staffing **[Commentary to NYSE Corporate Governance Rule 7(c) (iii) (F)]**.

Ethical Compliance, Legal Compliance, and Risk Management

28. Oversee, review, and periodically update the company's code of business conduct and ethics⁵⁷ and the company's system to monitor compliance with and enforce this code.

29. Review, with the company's counsel, legal compliance and legal matters that could have a significant impact on the company's financial statements.

30. Discuss policies with respect to risk assessment and risk management, including appropriate guidelines and policies to govern the process, as well as the company's major financial risk exposures and the steps management has undertaken to control them **[NYSE Corporate Governance Rule 7(c)(iii)(D)]**.

⁵ Though not required, many companies have a process in place by which the internal and external auditors evaluate each other on an annual basis. Should the audit committee choose to include the responsibility to review any such evaluations, the following language may be used: "Review the results of the annual evaluation of the internal audit function by the independent auditor and the review of the independent auditor by the internal audit function. Recommend improvements as necessary."

⁶ NYSE Corporate Governance Rule 7(d) requires each listed company to have an internal audit function. The NYSE commentary indicates that this function does not have to be a separate department and may be outsourced if the company chooses. Language regarding the internal audit function should be reviewed and modified if necessary to reflect the nature and composition of such function at a given company.

⁷ The audit committee charter should include item 28 if the audit committee, rather than another committee, assumes responsibilities with respect to ethical compliance.

⁸ NYSE Corporate Governance Rule 10 and NASDAQ Corporate Governance Rule 4350(n) require listed companies to maintain a code of business conduct and ethics. The rules do not require the audit committee to be responsible for establishing, maintaining, and overseeing enforcement of this code, but some companies do assign such authority to the audit committee.

Other Responsibilities

31. Review, with the independent auditor, the internal audit function, and management, the extent to which changes or improvements in financial or accounting practices have been implemented.
32. Prepare the report that the SEC requires be included in the company's annual proxy statement **[NYSE Corporate Governance Rule 7(c)(f)(6); Item 306 of Regulation S-K]**.
33. Conduct an annual performance assessment relative to the audit committee's purpose, duties, and responsibilities outlined herein **[NYSE Corporate Governance Rule 7(c)(ii)]**.
34. Perform any other activities consistent with this charter, the company's bylaws, and governing law that the board or audit committee determines are necessary or appropriate.

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Planning Tool: Audit Committee Calendar of Activities

Source: IIA Audit Committee: Purpose, Process, Professionalism



Planning Tool: Audit Committee Calendar of Activities

Excerpt from the Audit Committee Resource Guide

Audit committees can use this tool to help plan their annual activities and meeting agendas. It considers the requirements, as of June 21, 2006, for the audit committees of U.S. public companies, including NYSE- and NASDAQ-listed companies, as well as common practices in the marketplace. The "Results From:" section indicates if the action or responsibility results from a requirement of the Sarbanes-Oxley Act of 2002 and subsequent SEC rulemaking, the NYSE, the NASDAQ, the SEC (other than those requirements arising from the Sarbanes-Oxley Act), or a common or emerging practice. The action or responsibility, as described, may not be an explicit legislative or regulatory requirement or proposal, but may be an action that logically results from other legislative or regulatory requirements or proposals. The "Suggested Frequency" section offers a benchmark for how often the activity should be performed, while the "Meeting Month" section provides an area where the audit committee can mark the months in which an activity should be performed. The audit committee should use this tool in conjunction with Deloitte & Touche LLP's "Sample Audit Committee Charter" and it should be tailored to reflect the responsibilities in the company's audit committee charter.

This document is not an all-inclusive list of activities that an audit committee should or must execute. The planning tool contains general information only and does not constitute, and should not be regarded as, legal or similar professional advice or service. It is not a substitute for such professional advice or services, nor should it be used as a basis for any decision or action that may affect you or your business. Any such decision or action should be taken only with the advice of a qualified professional advisor. Neither Deloitte & Touche LLP nor any of its affiliates or related entities have any liability or responsibility to any person or entity with respect to their use of or reliance on this document.

This planning tool is designed for U.S. public companies; exceptions to the requirements noted below may apply for certain issuers, including investment companies, small-business issuers, and foreign private issuers. Many of the items presented here are not applicable to voluntary filers. All companies should consult with legal counsel regarding the applicability and implementation of the various activities identified.

Action/Responsibility	Results From:					Suggested Frequency	Meeting Month												
	Sarbanes-Oxley Act/SEC Requirement	NYSE Listing Standards	NASDAQ Listing Standards	Other SEC Requirements	Common Practice		January	February	March	April	May	June	July	August	September	October	November	December	
General Responsibilities																			
Review audit committee members' compliance with applicable independence rules and regulations.	●	●	●			Annually and as needed													
As necessary, engage outside legal, accounting, or other advisors and provide funding to compensate those advisors.	●	●	●			As needed													
Report regularly to the board of directors regarding the execution of duties and responsibilities.		●			●	Each board meeting													
Review the financial literacy and expertise of all audit committee members. Determine audit committee financial expert status and determine that members are in compliance with applicable rules and regulations.	●	●	●			Annually													

Action/Responsibility	Results From:					Suggested Frequency	Meeting Month												
	SEC Requirements	NYSE Listing Standards	NASDAQ Listing Standards	Other SEC Requirements	Common Practice		January	February	March	April	May	June	July	August	September	October	November	December	
<p>Action/Responsibility</p> <p>Disclose in the Form 10-K (or equivalent annual filing) whether at least one member of the audit committee has been determined to be an "audit committee financial expert," as defined by the SEC. If the board determines that someone on the audit committee meets the definition, disclose his/her name and whether he/she is independent. If more than one audit committee member is determined to fulfill the definition, determine if the names and independence of those individuals will be disclosed. If there is not an audit committee financial expert, disclose why not.</p> <p>Conclude each regular audit committee meeting with an executive session of the committee, without members of management.</p> <p>Periodically, meet with management privately to discuss any necessary matters.</p> <p>Consider and plan for succession of audit committee members.</p>	●					Annually													
<p>Review of Financial/Controls Information</p> <p>Review and discuss with management and the independent auditors the company's annual financial statements prior to filing, including the company's disclosure under "Management's Discussion and Analysis of Financial Condition and Results of Operations."</p> <p>Recommend to the board of directors whether the financial statements should be included in the annual report on Form 10-K.</p> <p>Review and discuss with management and the independent auditors the company's quarterly financial statements prior to their filing, including the company's disclosure under "Management's Discussion and Analysis of Financial Condition and Results of Operations."</p> <p>Review the internal controls report required under Section 404 of the Sarbanes-Oxley Act.</p> <p>Review management certifications required under Sections 302 and 906 of the Sarbanes-Oxley Act.</p> <p>Review other reports rendered by the independent auditors and submitted by the company to any governmental body or the public.</p> <p>Discuss earnings press releases, including the type and presentation of information, paying particular attention to any pro forma or adjusted non-GAAP information. This discussion may be in general terms.</p>		●		●		Annually													

Action/Responsibility	Results From:						Suggested Frequency	Meeting Month																			
	Sarbanes-Oxley Act/Requirement	NYSE Listing Standards	NASDAQ Listing Standards	Other SEC Standards	Requirement	Common Practice		January	February	March	April	May	June	July	August	September	October	November	December								
Action/Responsibility																											
Discuss the financial information and earnings guidance provided to analysts and ratings agencies. This discussion may be in general terms.							●																				
Review the regular internal reports to management prepared by the internal audit function and management's response.																											
Independent Auditor Relationship																											
Appoint the independent auditor.	●						●																				
Compensate, retain, and oversee the work of the independent auditor for the purpose of preparing or issuing an audit report or related work.	●		●				●																				
Review the performance of the independent auditor, including the lead audit partner. Ensure that partners are rotated in accordance with applicable requirements.		●					●																				
Preapprove audit and nonaudit services provided by the independent auditor.	●																										
Consider the independence of the auditor, including engaging in dialogue with the independent auditor with respect to any disclosed relationships or services that may affect the independence and objectivity of the auditor and take appropriate actions to oversee independence.		●					●																				
Oversee the resolution of disagreements between management and the independent auditor if they arise.	●																										
Review with the independent auditor any problems or difficulties encountered in the course of the audit and management's response.							●																				
Review the audit plan and scope with the independent auditor.																											
Prior to filing periodic financial statements, receive the report from the independent auditor required by Section 204 of the Sarbanes-Oxley Act. This report includes:	●																										
- Critical accounting policies																											
- Alternative treatments of financial information within GAAP related to material items that have been discussed with management, the ramifications of using these alternative disclosures and treatments, and the treatment preferred by the independent auditor																											
- Other material written communications between the independent auditor and management, including (but not limited to) the management letter and schedule of unadjusted differences.																											

Action/Responsibility	Results From:					Suggested Frequency	Meeting Month												
	Sarbanes-Oxley Act SEC Requirement	NYSE Listing Standards	NASDAQ Listing Standards	Other SEC Requirements	Common Practice		January	February	March	April	May	June	July	August	September	October	November	December	
<p>Action/Responsibility</p> <p>Receive from the independent auditor the communications required by Statement on Auditing Standards (SAS) No. 61, as amended by SAS No. 84 and SAS No. 90.</p> <p>Periodically, meet with the independent auditor privately to discuss any matters necessary.</p> <p>Review hiring policies for personnel of the independent auditor.</p> <p>Obtain and review a report by the independent auditor describing:</p> <ul style="list-style-type: none"> - The independent auditor's internal quality-control procedures - Any material issues raised by the most recent internal quality-control review, peer review, or any inquiry or investigation by governmental or professional authorities, within the preceding five years, with respect to independent audits carried out by the independent auditor, and any steps taken to deal with such issues - All relationships between the independent auditor and the company. 					●														
<p>Financial Reporting Processes, Accounting Policies, and Internal Control</p> <p>In consultation with the independent auditor and the internal audit function, review the integrity of the company's financial reporting processes (both internal and external) and the internal control structure (including disclosure controls and procedures and internal control over financial reporting).</p> <p>Meet with representatives of the disclosure committee to discuss any anomalies encountered in the Sarbanes-Oxley Section 302 certification process.</p> <p>Review with management major issues regarding accounting principles and presentation of the financial statements, including any significant changes in the company's selection or application of accounting principles, major issues as to the adequacy of the company's internal controls, and any special audit steps adopted in response to material control deficiencies.</p> <p>Review management's analyses of financial reporting issues and judgments made in connection with the preparation of the financial statements, including analyses of the effects of alternative GAAP methods on the financial statements.</p> <p>Review with management the effect of regulatory and accounting initiatives, as well as off-balance-sheet structures, on the financial statements of the company.</p> <p>Review and approve all related-party transactions.</p>		●			●														

Action/Responsibility	Results From:					Suggested Frequency	Meeting Month											
	Sarbanes-Oxley Act/SEC Requirement	NYSE Listing Standards	NASDAQ Listing Standards	Other SEC Requirements	Common Practice		January	February	March	April	May	June	July	August	September	October	November	December
Review the adequacy of procedures for the receipt, retention, and treatment of complaints regarding accounting, internal control, or auditing matters, including procedures for confidential, anonymous submissions by company employees.	●	●	●			Annually												
Receive and review reports or complaints of questionable accounting, auditing, or internal control matters.	●	●	●			Semiannually or quarterly												
Internal Audit Activities																		
Review and advise on the selection or removal of the internal audit director.					●	As needed												
Periodically, meet with the director of the internal audit function privately to discuss any necessary matters.					●	Quarterly												
Periodically, review with the internal audit director any significant difficulties, disagreements with management, or scope restrictions encountered in the course of the function's work.					●	Annually												
Review the activities and organizational structure of the internal audit function, as well as the qualifications of its personnel.					●	Annually												
Review the internal audit charter and recommend any necessary changes.					●	Annually												
Periodically review, with the independent auditor, the internal audit function's responsibilities, budget, and staffing.					●	Annually												
Ethical Compliance, Legal Compliance, and Risk Management																		
Review the company's code of ethical conduct and the company's systems to monitor compliance with and enforce this code. Determine whether the code is in compliance with applicable rules and regulations.					●	Annually												
Receive and review reports of code violations and how they were identified and treated.					●	Quarterly												
In consultation with the company's legal counsel, review legal compliance and legal and regulatory matters that could have a significant impact on the organization's financial statements.					●	Semiannually or more often as needed												
Discuss with management significant risk exposures, including major financial and accounting risk exposures, and the steps taken by management to control them.					●	Annually												

Action/Responsibility	Results From:					Suggested Frequency	Meeting Month											
	SEC Requirement	NYS Listing Standards	NASDAQ Listing Standards	Other SEC Requirements	Common Practice		January	February	March	April	May	June	July	August	September	October	November	December
Other Responsibilities																		
Review the audit committee charter; recommend to the board of directors any necessary amendments, as conditions dictate.						●												
Review, with the independent auditors, the internal audit function, and management, the extent to which changes or improvements in financial or accounting practices, as approved by the audit committee, have been implemented.																		
Prepare the report that the SEC requires to be included in the company's annual proxy statement.						●												
Participate in appropriate continuing education.																		
Assess performance relative to the audit committee's purpose, duties, and responsibilities.																		

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Audit Committee AICPA Self Evaluation

Source: IIA Audit Committee: Purpose, Process, Professionalism

Conducting an Audit Committee Self-Evaluation: Guidelines and Questions

PURPOSE OF THIS TOOL: Auditing committees should conduct a self-evaluation on an annual basis. This can be accomplished in a number of different evaluation formats and scenarios (through the use of outside evaluators, a 360-degree evaluation format, and other methods). The sample questions included in this tool are only a starting point to evaluating the performance and effectiveness of the audit committee. Follow-up questions are encouraged and the committee should plan for further action as appropriate.

An audit committee should conduct a comprehensive self-evaluation on an annual basis. The self-evaluation can take different forms, involve a number of participants, and use diverse techniques. Most important, however, the self-evaluation should adopt a straightforward approach that will aid the audit committee in assessing its strengths and weaknesses and lay a foundation for future improvement. Some guidelines in designing the format for self-evaluation would include the following areas of consideration.

1. *Introspection.* Be introspective. Evaluate the audit committee's performance by asking specific questions about the impact it has had on the organization, and most importantly, its financial reporting process, the annual audit, the relationship with the independent auditor, and members of management. Include the chair of the board in this evaluation session and ask for his or her input as well.
2. *Comprehensive.* Conduct 360-degree evaluations of all audit committee members and the committee chair. The chair should consider the result of the audit committee members' evaluations of each other in the context of the chair's evaluation of the members. The chair should consider whether any members of the committee should be rotated off the committee; this should be done in consultation with the chair of the board. The members' attendance record and level of participation should be considered during this process.
3. *Performance Improvement.* Ask the chief audit executive, chief financial officer, chief executive officer, and independent auditor for comments on the performance of the audit committee. Include this constructive feedback in the session referred to at item 1 above.
4. *Competency.* Use tools that are available, including the AICPA Competency Self-Assessment Tool (CAT) to evaluate performance. The CAT is available at <http://www.cpa2biz.com/CPEConferences/CAT.htm>.
5. *Leadership.* The members should talk about the performance of the chair. If the members collectively agree that the chair is not performing at the level needed, then the members should bring their concerns to the attention of the chair of the board, and/or the chair of the corporate governance committee, if there is one.

INSTRUCTIONS FOR THIS TOOL: The sample questions provided in this tool are only a starting point to evaluating the performance and effectiveness of the audit committee. Prior to completion, the committee should determine how it can best ensure that responses reflect a forthright exchange of ideas and opinions among audit committee members. The committee should determine how the process should be completed. The following sample questions can be completed anonymously, prior to attending an evaluation discussion meeting, or during a session of the committee. Discuss the following questions and include notes and comments if you feel further action is appropriate.

1. Does the committee have a positive working relationship with management, the internal auditors and the independent auditors?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	
2. Does the committee challenge management, the internal auditors, and the independent auditors with its own view on issues?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	
3. Are differences of opinion on issues resolved to the satisfaction of the committee?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	
4. Do the members challenge the chair as appropriate?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	
5. Is the audit committee charter used as a document to guide the committee in its efforts, and to help guide the committee's agenda? Is the audit committee charter matrix used to document compliance with the precepts of the charter?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	
6. Are the members financially literate?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	
7. Does the committee engage outside experts as appropriate?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	
8. Are the organization's financial reporting processes stronger as a result of management's interactions with the audit committee?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	
9. Is the committee cognizant of the line between oversight and management, and does it endeavor to respect that line?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	

Conducting an Audit Committee Self-Evaluation

Audit Committee Self-Evaluation Tool	Yes	No	No Score	Comments
10. Does the committee conduct executive sessions in a manner that offers a "safe haven" to the individual, while at the same time asking tough and necessary questions, evaluating the answers, and pursuing issues that might arise to a satisfactory resolution?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	
11. Do audit committee members participate in some form of continuing education to stay abreast of changes in the financial accounting and reporting, regulatory and ethics areas?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	
12. Does the committee do its part to ensure the objectivity of the internal audit team?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	
13. Does the committee provide constructive feedback to the chief audit executive at least annually?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	
<i>Additional Questions</i>				
	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	
	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	
	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	
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	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	
	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	

The AICPA Audit Committee Toolkit

Audit Committee Self-Evaluation Tool	2011
Other Self-Evaluation Notes	

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Basic Financial Literacy Self Assessment Tool

Source: IIA Audit Committee: Purpose, Process, Professionalism



Basic Financial Literacy Self-Assessment Tool

The Basic Financial Literacy Self-Assessment Tool, produced by Deloitte & Touche LLP (“Deloitte & Touche”), includes questions on basic financial accounting and reporting issues (please note, some of the questions relate to issues faced only by SEC registrants). Audit committee members should not infer that answering most, or even all, of these questions correctly represents a “passing” grade in basic financial literacy. These multiple-choice questions are not intended to cover all topics that an audit committee member may need to understand to be considered financially literate for the company he or she serves. It was designed to identify members who may require more focused financial literacy education than other members of the audit committee.

In addition to the very basic concepts presented in the tool, audit committee members should consider whether they can answer questions around key accounting and financial accounting and reporting issues, such as those listed below:

Do I understand the revenue recognition policy of the company?

Considerations:

- How is cash generated by the sales of the company's products and services?
- Are there significant sales to related parties? If so, are the disclosures adequate?
- Is a large portion of the company's revenue recorded at the end of a fiscal period? If so, are cut-off procedures adequate?

- How do the company's revenue recognition policies differ from others in the industry?

Which amounts and balances in the financial statements are subject to the highest level of management judgment?

Considerations:

- Does the company have significant employee benefit obligations? If so, what are the key assumptions that have been used to calculate the related liability?
- Is the company self-insured for general liability, workers' compensation, or other risks typically covered by insurance?
- How does the company calculate significant reserves, such as warranty, bad debt, and inventory reserves?

Are the company's disclosures adequate?

Considerations:

- What are the most significant accounting policies?
- Who are the company's significant related parties?
- Does the company have unique financing arrangements?
- Is the company's capital structure complex?

Deloitte & Touche has also created an additional financial literacy assessment tool: The Advanced Self-Assessment Tool. Audit committees are encouraged to consider and tailor each of these tools as part of a broad assessment of financial literacy.

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1. **The balance sheet**
 - a. Is a financial snapshot, taken at a point in time, of the assets the company owns and the claims against those assets.
 - b. Records the flow of financial resources over time.
 - c. Reports the operating results of a company for a period of time.
 - d. Is prepared by the auditors.
 - e. Both a and d are correct.
2. **Shareholders' equity (owners' equity, stockholders' equity, net worth, or equity)**
 - a. Is a source of reserve assets consisting of undistributed income.
 - b. Is the amount of cash contributed by the shareholders.
 - c. Includes shareholder contributions and undistributed income.
 - d. Is dependent on the company's stock price fluctuations.
 - e. Both c and d are correct.
3. **Basic earnings per share (EPS) is calculated by**
 - a. Dividing net income by the number of common shares outstanding at the end of the reporting period.
 - b. Dividing net income by the weighted average number of preferred and common stock outstanding during the reporting period.
 - c. Dividing income before taxes by the number of common shares outstanding at the end of the reporting period.
 - d. Dividing net income attributable to common shareholders by the weighted average number of common shares outstanding during the reporting period.
 - e. Varies from company to company.
4. **Financial statements to be filed with the SEC should be prepared**
 - a. Following the IRS Code.
 - b. As the company's financing agreements dictate or prescribe.
 - c. Following generally accepted accounting principles or "GAAP."
 - d. Using the practices followed by others in the same industry.
 - e. All of the above.
5. **Which of the following is a source of authoritative financial accounting literature?**
 - a. Financial Accounting Standards Board (FASB) statements.
 - b. Securities and Exchange Commission (SEC) rules and regulations.
 - c. Emerging Issues Task Force (EITF) abstracts.
 - d. Accounting Principles Board (APB) opinions.
 - e. American Institute of Certified Public Accountants (AICPA) accounting interpretations.
 - f. All of the above.
6. **The term "cookie jar reserve" has been used to refer to**
 - a. A vehicle that allows management to smooth earnings by reducing income in "good" years and increasing income in "bad" years.
 - b. Any liability or contra-asset that is larger than what management can justify.
 - c. A reserve that is created using overly conservative estimates.
 - d. All of the above.
7. **Which of the following balance sheet items generally do not require management to make significant judgments and/or estimates?**
 - a. Inventory at lower of cost or market
 - b. Net receivables
 - c. Cash
 - d. Accrued liabilities
 - e. Both a and c are correct
8. **A company should only consolidate its financial statements with a company in which it owns 50 percent or more equity shares.**
 - a. True
 - b. False
9. **Which of the following is NOT true of related-party transactions?**
 - a. Only transactions requiring material cash payments between related parties need to be disclosed.
 - b. A company cannot indicate in its financial statements that related-party transactions were consummated under terms that were similar to those that could have been achieved in an arms-length transaction unless this representation can be substantiated.
 - c. The substance of related-party transactions is more important than their form.
 - d. All of the above are true of related-party transactions.
10. **A sale can be recorded when delivery has NOT occurred if several criteria are met, including**
 - a. Risk of ownership has passed to the buyer.
 - b. There is a sales commitment.
 - c. There is a fixed delivery date.
 - d. All of the above are required.
 - e. Both a and c are required.

I. Basic Financial Statements and Accounting Literature continued

11. Management is required to record any adjustments that the auditors propose.

- a. True
- b. False

12. An amount is always immaterial to the financial statements if it is less than

- a. 10 percent of income before taxes.
- b. 10 percent of shareholders equity.
- c. 2 percent of net assets.
- d. None of the above.

13. Financial ratios are tools that allow you to understand the economic activity of a company without having to understand accounting.

- a. True
- b. False

14. The quick ratio, a tool used to assess liquidity, is defined as

(Current assets - Inventory)

Current liabilities

- a. True
- b. False

II. Disclosure Rules

1. Which of the following is NOT considered a financial disclosure for a public company?

- a. Management Discussion & Analysis (MD&A)
- b. Earnings announcements.
- c. The company's financial statements.
- d. All of the above are forms of financial disclosure.
- e. Both a and c are financial disclosures.

2. Which of the following financial information is covered by the independent auditors' report?

- a. Earnings announcements
- b. Pro forma earnings releases
- c. The footnotes to the financial statements
- d. MD&A
- e. All of the above

3. Which of the following items is NOT expected to be addressed in MD&A?

- a. The most critical accounting policies used to prepare the financial statements.
- b. Liquidity and capital resources.
- c. Any item that helps investors assess the company's current condition and future prospects.
- d. All of the above are expected to be addressed in MD&A.

4. Which of the following is NOT a required disclosure for a significant loan agreement?

- a. Interest rate
- b. Significant covenants
- c. Name of the lender
- d. Schedule of maturity
- e. All of the above are required to be disclosed.

5. If a company presents permitted non-GAAP measures, such amounts

- a. Should be disclosed along with a detailed reconciliation to, or from, GAAP amounts and disclose the amount for each item.
- b. Must have a footnote that explains in general terms how the amount was calculated — typically a formula is sufficient.
- c. Have been banned by the SEC under the antifraud provisions of the federal securities laws.
- d. Both a and c are correct.

6. Non-cash charges, such as for asset impairments,

- a. Should be ignored during most analyses, as they do not have an impact on the cash flows of the company.
- b. Should be ignored during most analyses only if they are non-recurring charges and are not indicative of the ongoing operations of the company.
- c. Can be put "below the line" on the income statement to signal to investors that the item should be removed before analysis.
- d. Are the results of situations that may have diminished the economic value of the company.
- e. None of the above.

III. Form and Content of SEC Filings

1. The primary objective of the SEC is to prevent the sale of risky or speculative securities.

- a. True
- b. False

2. Which of the following is NOT a required SEC filing?

- a. Private equity offering
- b. Annual and quarterly reports
- c. Annual proxy statement
- d. Registration statements
- e. Both b and d

3. Which of the following is true about the Form 10-K?

- a. Contains the annual financial statements of the company.
- b. Contains an audit report on the included financial statements.
- c. Is subject to SEC review.
- d. All of the above are true.

4. Which of the following is NOT true about the Form 10-Q?

- a. Contains the quarterly financial statements of the company.
- b. Contains an audit report on the included financial statements.
- c. Is subject to SEC review.
- d. Contains footnotes to the financial statements.

5. A Form 8-K is required to be filed

- a. After a significant acquisition.
- b. After a change in auditors.
- c. A company is never required to file a Form 8-K, but companies often do so at their own discretion to notify investors of significant events.
- d. Both a and b

IV. Internal Controls

1. Internal controls are designed to provide reasonable assurance over the

- a. Effectiveness and efficiency of operations.
- b. Reliability of financial reporting and information.
- c. Compliance with applicable laws and regulations.
- d. All of the above.
- e. Both b and c.

2. An effective system of internal control will always prevent and detect fraud.

- a. True
- b. False

3. Who is responsible for the design and effectiveness of the company's internal controls?

- a. Management
- b. Internal audit
- c. External audit
- d. The audit committee
- e. All of the above

4. Under Section 302 of the Sarbanes-Oxley Act, management is required to certify that it has disclosed which of the following to its auditor and audit committee?

- a. Significant deficiencies in the design and operation of internal controls which could adversely affect the company's ability to record, process, summarize and report financial data.
- b. The method used in designing the company's internal control framework.
- c. Fraud involving employees who have a significant role in the company's internal controls.
- d. Both a and c are correct.

5. Which of the following organizations developed the most widely accepted internal control framework in the United States?

- a. The Accounting and Internal Controls Program Administration
- b. The Committee of Sponsoring Organizations of the Treadway Commission
- c. The Public Company Accounting Oversight Board
- d. The Securities and Exchange Commission

I. Basic Financial Statements and Accounting Literature

1. A is correct. The objective of the balance sheet is to present the financial condition of a company at a particular point in time.
2. C is correct. Shareholders' equity may include a number of other items as well, such as treasury stock and certain unrealized gains and losses.
3. D is correct. Detailed guidance on earnings per share can be found in Statement of Financial Accounting Standards No. 128, *Earnings Per Share*.
4. C is correct. Financial statements filed with the SEC are required to follow GAAP. Although it is the intention that companies in the same industry would follow similar practices, the overriding authority is GAAP.
5. F is correct.
6. D is correct. "Cookie jar reserve" is a term that was used by former SEC chairman Arthur Levitt to refer to cost over accruals and other estimates often used to manage the earnings of a company. Management should record all contingent liabilities using the guidance of Statement of Financial Accounting Standards No. 5, *Accounting for Contingencies*.
7. C is correct. Most balance sheet items require significant estimates or judgments, including inventory (e.g. obsolescence reserves), accounts receivable (e.g. allowance for doubtful accounts), and accrued liabilities (e.g. warranty reserves).
8. B is correct. Generally, when a company has the ability to control another company's policies, management, and operations, the two companies should be presented as a single company. Refer to Statement of Financial Accounting Standards No. 94, *Consolidation of all Majority-Owned Subsidiaries*, for further guidance. In addition, FASB Interpretation No. 46R, *Consolidation of Variable Interest Entities, an Interpretation of Accounting Research Bulletin ARB No. 51 (FIN 46R)* introduced the variable interest consolidation model, which must be applied to variable interest entities. The interpretation relies on an analysis of potential variability in expected losses and residual returns of an entity to determine the parties that consolidate a variable interest entity.
9. A is correct. The materiality of the cash payments between related parties is not relevant to determine if a transaction needs to be disclosed. A noncash transaction between related parties must also be disclosed.
10. D is correct. Refer to the SEC's Staff Accounting Bulletin No. 101 and 104, *Revenue Recognition in Financial Statements*, for further guidance.
11. B is correct. Management is not required to record proposed audit adjustments; however, if the auditors determine that the financial statements are materially misstated, they will qualify their opinion accordingly.
12. D is correct. The calculation of materiality is a matter of professional judgment, and there is no single threshold that is applied to all companies.
13. B is correct. Without an understanding of the accounting policies used by a company to prepare the financial statements, financial ratios are of little value.
14. B is correct. There is no authoritative standard for financial ratios.

II. Disclosure Rules

1. D is correct. All of these items are financial disclosures.
2. C is correct. Although all of these items consist of accounting information, A, B, and D are not covered by the independent auditors' report.
3. D is correct. Generally, all of these items are expected to be discussed in MD&A.
4. C is correct. There is no GAAP requirement to disclose the name of the lender; however, all the remaining items must be disclosed for each material loan agreement.
5. A is correct. In conjunction with the Sarbanes-Oxley Act, the SEC adopted rules governing the use of non-GAAP financial measures. Issuers using non-GAAP financial measures are required to provide, (i) directly comparable GAAP financial measures, (ii) a reconciliation between GAAP and non-GAAP, and (iii) a statement disclosing the reasons management believes the non-GAAP financial measures are useful. See Regulation G and Item 10 of Regulations S-K and S-B for additional information.
6. D is correct. Noncash transactions are often disregarded as "paper losses," as they do not result from cash outflows; however, these transactions, such as the write-down of a significant investment, clearly have negative economic implications to the company and in some instances require appropriate disclosure.

III. Form and Content of SEC Filings

1. B is correct. The SEC's primary mission is to protect investors and maintain the integrity of the securities markets. Its focus is to provide timely and accurate information for investors to make informed investment choices, not to restrict risky or speculative issuances.
2. A is correct. All of the remaining items are required SEC filings.
3. D is correct.
4. B is correct. Auditors perform limited review procedures on the financial statements included in the Form 10-Q, and may, in some circumstances, issue a review report. These review procedures are not adequate to allow the issuance of an audit opinion.
5. D is correct.

IV. Internal Controls

1. D is correct. A control is an activity that prevents or detects errors. An internal control is an activity or process that occurs using the company's internal systems or personnel. Accordingly, although internal controls are crucial to a company's financial reporting and information, their use is not limited to financial reporting.
2. B is correct.
3. A is correct. Under Section 404, management is also required to certify their responsibility for establishing and maintaining adequate internal controls over financial reporting.
4. D is correct. Management must report fraud, whether or not material, as well as significant deficiencies and material weaknesses in the company's internal controls.
5. B is correct. The Committee of Sponsoring Organizations of the Treadway Commission (COSO) is an organization dedicated to improving the quality of financial reporting through effective business ethics, corporate governance and internal controls.

Our Commitment to Effective Corporate Governance

Deloitte & Touche has a number of programs and initiatives that demonstrate its commitment to help boards and audit committees enhance their effectiveness and overall corporate governance.

Customized Board and Audit Committee Education Programs.

• Instructor-Led Director Programs.

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To learn more, contact your Deloitte & Touche partner or e-mail us at corp.governance@deloitte.com.

Audit Committee Online

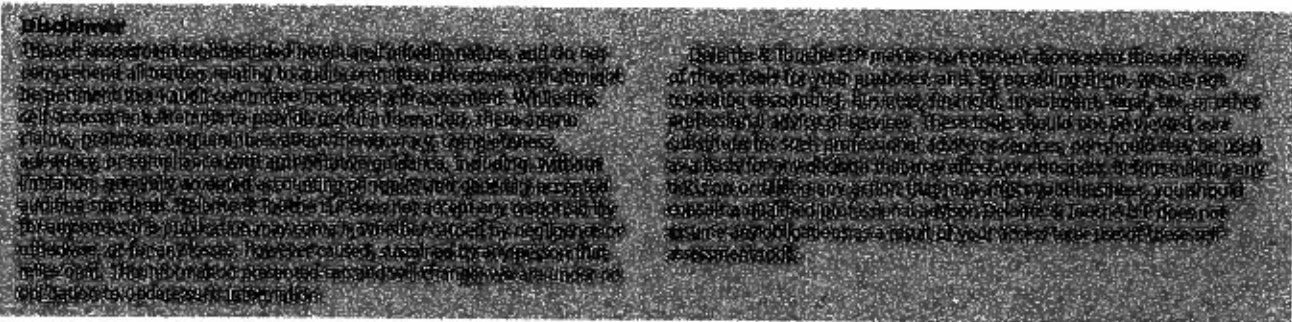
A Web site designed to assist audit committee members and management with their responsibilities by providing information on regulatory and legislative developments, accounting and financial reporting, audit committee roles and responsibilities, tools, and best practices. Visit us at www.auditcommittee.com.

Financial Executives Research Foundation (FERF) and Deloitte & Touche

A virtual roundtable series with FERG, a professional association for senior financial executives.

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The Center for Corporate Governance

Source: IIA Audit Committee: Purpose, Process, Professionalism

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The Center for Corporate Governance

An Essential Tool for Board Members
www.corpgov.deloitte.com



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Expectations for good governance continue to grow as the focus on corporate risk, integrity in financial reporting, and regulatory compliance intensifies. With these rising expectations comes the need for fresh approaches, inspired thinking, and new resources.

Deloitte's Center for Corporate Governance Web site meets that need.

Boards of directors, associated committees, outside executives, and investors can access a key resource to learn more about governance and related issues. The Center for Corporate Governance offers information that is objective, thought-provoking, and easy to use. Selected by partners and senior management of Deloitte, this in-depth material is updated regularly.

Register for the Center for Corporate Governance Web site at www.corpgov.deloitte.com by clicking register at the top right of the screen.

Included on the site are insightful materials regarding:

Audit Committees – Learn about the role of the committee, performance evaluations, working with internal and external auditors, whistle-blower provisions, and risk oversight.

Board Governance – Find answers to such questions as: What are the roles and responsibilities of the board? How does a company develop and evaluate its board members? What are the essential elements of an effective ethics and compliance program?

Compensation Committees – Read more about the changing responsibilities of this committee following the adoption of the SEC's executive compensation disclosure rules.

Nominating/Corporate Governance Committees – Find out about the role and responsibility of this committee, and read thought-leadership articles in such areas as board composition and diversity, director recruiting, and proxies.

Going beyond compliance matters, the Center for Corporate Governance contains:

- Tools and resources for audit committee effectiveness
- Insights on board practices and composition
- A current list of important webcasts, podcasts, and events focused on governance issues.

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